Supreme Court, U.S.
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No. 03-1581

In The

Supreme Court of the United States

KNIGHT-RIDDER, INC.,

Petitioner,

v.

CAPITAL FACTORS, INC.,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Section 363(b)(1) of the Bankruptcy Code provides that the trustee or debtor-in-possession, "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b)(1). The Second, Fifth, Sixth Circuits (and the Seventh Circuit heretofore) require the debtor-in-possession to articulate a business justification before using estate property outside the ordinary course of business. The Seventh Circuit, in this case, adopted a new, more rigorous test for determining whether to grant a debtor-in-possession's request to use estate property to pay the prepetition claims of critical vendors under section 363(b)(1) prior to confirmation of a plan. The question presented is:

Whether section 363(b)(1) of the Bankruptcy Code authorizes a debtor to use estate property to pay the claims of critical vendors prior to confirmation if the debtor articulates a sound business reason for doing so.

PARTIES TO THE PROCEEDINGS AND RULE 29.6 STATEMENT

Petitioner Knight-Ridder, Inc. ("Knight Ridder") was an appellant below. Respondent Capital Factors, Inc. was the appellee below. Kmart Corporation, Handleman Company and Irving Pulp and Paper Limited were also appellants below.

Pursuant to S. Ct. Rule 29.6, petitioner Knight Ridder states that it is not held by any parent corporations, and that no publicly held company owns 10% or more of the stock of Knight Ridder.

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PETITION FOR A WRIT OF CERTIORARI

Knight-Ridder, Inc. ("Knight Ridder") respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the Seventh Circuit affirming the District Court's judgment is reported at 359 F.3d 866 (7th Cir. 2004) and reprinted in the appendix hereto ("App.") at 1a-13a. The opinion of the District Court reversing the Bankruptcy Court's order is reported at 291 B.R. 818 (N.D. Ill. 2003) and reprinted at App. at 14a-26a. The underlying order of the Bankruptcy Court is not reported and is reprinted at App. at 27a-32a.

JURISDICTION

The order of the court of appeals was entered on February 24, 2004. This petition for a writ of certiorari has been filed within 90 days of such order. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISION INVOLVED

Section 363(b)(1) of the Bankruptcy Code provides that a debtor-in-possession: "after notice and a hearing,

may use, sell, or lease, other than in the ordinary course of business, property of the estate."

INTRODUCTION

This case presents the question whether the bankruptcy court may authorize, under section 363(b)(1) of the Bankruptcy Code, a chapter 11 debtor-in-possession to pay the prepetition claims of certain vendors deemed critical to the debtor's reorganization efforts, outside of the provisions of a plan of reorganization, if the debtor articulates a sound business purpose for doing so. The Seventh Circuit held that such an authorization could be grounded in the provisions of 11 U.S.C. § 363(b), but articulated a new standard for judging requests for approval of "critical vendor payments." That new standard is contrary to the accepted judicial standard for section 363(b) approval that has been articulated by the courts of appeal and is contrary to the policies of chapter 11 reorganization articulated by this Court.

Review should be granted because:

First, the Seventh Circuit's decision conflicts with the decisions of every federal circuit court that has considered the appropriate standard for authorizing the non-ordinary use of estate funds under 11 U.S.C. § 363(b)(1). S. Ct. Rule 10(a).

Second, the decision of the Seventh Circuit conflicts with this Court's *Bildisco* decision. S. Ct. Rule 10(a).

Third, the Seventh Circuit's decision, if followed, would seriously affect the feasibility of reorganizations under chapter 11. S. Ct. Rule 10(c).

STATEMENT OF THE CASE

On January 22, 2002 (the "Petition Date"), the third largest general merchandise retailer in the country, Kmart Corporation ("Kmart"), along with certain of its domestic subsidiaries and affiliates, filed a petition for relief under chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code") in the United States Bankruptcy Court for the Northern District of Illinois (the "Bankruptcy Court").

On the first day of its bankruptcy case, Kmart sought authorization to exercise its business judgment to pay its prepetition obligations to certain vendors it deemed critical to the success of its reorganization. Among the vendors that Kmart sought to pay were the corporate owners of this country's major newspapers, including Knight Ridder, Newhouse Advance Newspapers, The Hearst Corporation, McClatchy Company, Media General, Inc., The Washington Post Company, The Copley Press, Inc., Belo Corp., Tribune Company, Journal Register Company, Lee Enterprises, Incorporated, Medianews Group, Inc., Times Publishing Company and Daily News, L.P.

The Bankruptcy Court held a hearing on Kmart's request to pay its critical vendors. At the hearing, Kmart presented the testimony of Charles C. Conaway, its Chief Executive Officer. Mr. Conaway testified that Kmart's entire weekly sales volume is driven by its weekly advertising circular program, under which newspapers distribute 78 million circulars every week. Advertised items account for approximately 30%, or $11 billion, of Kmart's annual sales, and that continuation of the program was critical to the ongoing health of the business. Absent

continuation of the advertising program, the entire health of Kmart's business would be severely jeopardized because there is simply "no alternative in most of the major markets." App. at 55a. In addition, Kmart's ability to maintain good relations with its newspapers was crucial because, absent a good relationship, the newspapers could place Kmart's advertisements in unfavorable locations in the newspaper, which has "a significant impact on sales." App. at 64a. The CEO testified that failing "to get placement in an ad program . . . would be devastating to . . . our overall business model" and would seriously threaten Kmart's ability to successfully reorganize. App. at 55a.

The sole objector at the hearing was Capital Factors, Inc. ("Capital"), a factoring agent that had purchased roughly $20 million of accounts receivable from Kmart's vendors.

After hearing Mr. Conaway's testimony, the Bankruptcy Court overruled Capital's objection and granted Kmart's request to pay its critical vendors. The Bankruptcy Court stated:

> Motions to pay certain critical trade creditors always present difficult questions for courts. We're seeing more and more of them, and our problem is that we have to stretch to find some authority to do them. However, I, after hearing this testimony and reading the [Conaway] affidavit, am convinced that . . . the advertising concerns are necessary to keep this business going as a going concern.

App. at 66a. On January 25, 2002, the Bankruptcy Court entered a written order granting Kmart's motion to pay

the critical vendors (the "Critical Vendor Order"). App. at 27a-32a.

More than a year after the Bankruptcy Court granted Kmart's motion to pay its critical vendors, on April 8, 2003, the United States District Court for the Northern District of Illinois entered an order (the "District Court Order") reversing the Critical Vendor Order. The District Court adopted a *per se* rule: "[W]e hold that the bankruptcy court did not have either the statutory or equitable power to authorize the pre-plan payment of prepetition unsecured claims. . . ." App. at 21a (291 B.R. at 823).

The Seventh Circuit affirmed the District Court Order but on a different ground. The court assumed that critical vendor payments could be authorized under section 363(b)(1), which allows a debtor-in-possession to use property of the estate other than in the ordinary course of business, stating:

> This is more promising, for satisfaction of a prepetition debt in order to keep "critical" supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy.

App. at 10a (359 F.3d at 872).

However, instead of following the business judgment standard, which is universally applied to requests to use property of a debtor's estate outside the ordinary course of business, the court adopted a new standard for the application of section 363(b)(1) in connection with requests to make critical vendor payments. The new test framed by the court requires the debtor to establish that (1) creditors

in the same class as those to receive the critical vendor payments will be as well off in a reorganization as they would be if the debtor were to liquidate, and (2) in the absence of such payments, the proposed recipients would have ceased to do business with the debtor.

REASONS FOR GRANTING THE WRIT

I. THE DECISION CONFLICTS WITH THE DECISIONS OF EVERY FEDERAL COURT OF APPEALS THAT HAS CONSIDERED THE APPROPRIATE STANDARD FOR AUTHORIZING THE NON-ORDINARY USE OF ESTATE FUNDS UNDER 11 U.S.C. § 363(b)(1).

Twenty years ago, the United States Court of Appeals for the Second Circuit articulated the test governing an application to use or sell bankruptcy estate property outside the ordinary course of business under section 363(b) of the Bankruptcy Code. *Committee of Equity Security Holders v. The Lionel Corporation (In re The Lionel Corporation)*, 722 F.2d 1063 (2d. Cir. 1983). "The rule we adopt requires that a judge determining a §363(b) application expressly find from the evidence presented before him at the hearing a good business reason to grant such an application." *Lionel*, 722 F.2d at 1071. In the twenty years since *Lionel*, nearly every court has adhered to this standard of requiring a debtor to demonstrate a sound business purpose before the court will grant a section 363(b) application. *Stephens Industries, Inc. v. McClung*, 789 F.2d 386, 390 (6th Cir. 1986) ("We adopt the Second Circuit's reasoning in *In re Lionel Corporation, supra,* and conclude that a bankruptcy court can authorize a sale of all a chapter 11 debtor's assets under § 363(b)(1)

when a sound business purpose dictates such action."); *The Institutional Creditors of Continental Air Lines, Inc. v. Continental Air Lines, Inc. (In re Continental Air Lines, Inc.)*, 780 F.2d 1223, 1226 (5th Cir. 1986) ("We also agree with the Second Circuit that implicit in § 363(b) is the further requirement of justifying the proposed transaction. (citation omitted). That is, for the debtor-in-possession or trustee to satisfy its fiduciary duty to the debtor, creditors and equity holders, there must be some articulated business justification for using, selling, or leasing the property outside the ordinary course of business.").

The Seventh Circuit itself previously endorsed the *Lionel* rule. Citing the Fifth Circuit's decision in *Continental Air Lines*, the Seventh Circuit stated: "Under Section 363, the debtor in possession can sell property of the estate outside the ordinary course of business if he has an 'articulated business justification.'" *Fulton State Bank v. Schipper (In re Schipper)*, 933 F.2d 513, 515 (7th Cir. 1991).

In this case, the Seventh Circuit departed from the *Lionel* business-justification standard and articulated a new standard to be applied where a debtor-in-possession seeks to use estate property under section 363 to pay the claims of certain critical vendors prior to confirmation of a plan. No other court has deemed it necessary to apply a different standard in determining whether a debtor under section 363 may use estate funds to pay certain claims prior to confirmation. In an analogous situation, the United States District Court for the Southern District of New York recently adhered to the *Lionel* business-justification standard in upholding the bankruptcy court's decision under section 363(b) to allow the debtor to pay up to $1.5 million of professional fees incurred by the United Steel Workers of America. *U.S. Trustee v. Bethlehem Steel*

Corp. (In re Bethlehem Steel Corp.), 2003 U.S. Dist. LEXIS 12909 (S.D.N.Y., July 28, 2003). The appellant had argued that authorization to pay these claims is limited to sections 503(b)(3)(D) and (b)(4) of the Bankruptcy Code, which explicitly provide for payment of the expenses incurred by a creditor who makes a substantial contribution to a case. In affirming the bankruptcy court, the district court held that the "authorization of certain types of payments under § 363(b) is not prohibited simply because there is another section of the Bankruptcy Code related to the same type of payment." App. at 105a-106a. "To approve a transaction under § 363(b), the bankruptcy court must find that there is a good business reason to allow the transaction." App. at 106a-107a.

There is a strong federal interest in uniform application of the Bankruptcy Code. The decision of the Seventh Circuit to impose a new and unique standard applicable only to a section 363(b) application to pay certain claims prior to confirmation is in conflict with well-established precedent and substitutes uncertainty for uniformity in applying the Bankruptcy Code.

II. THE DECISION OF THE SEVENTH CIRCUIT CONFLICTS WITH THIS COURT'S *BILDISCO* DECISION.

This Court dealt with a similar issue when it determined the standard for authorizing a debtor to reject a collective bargaining agreement under section 365(a) of the Bankruptcy Code. *National Labor Relations Board v. Bildisco and Bildisco*, 465 U.S. 513 (1984). In *Bildisco,* the National Labor Relations Board and the International Brotherhood of Teamsters argued that in light of the special nature of rights created by labor contracts, a

debtor should not be permitted to reject a collective bargaining agreement unless the debtor could demonstrate that its reorganization would fail unless rejection was permitted. *Id.* at 525. That was the standard that had been adopted by the Second Circuit in *Brotherhood of Railway and Airline Clerks v. REA Express, Inc.*, 523 F.2d 164, 167-69 (2d Cir.), *cert. denied*, 423 U.S. 1017 (1975).

This Court rejected the Second Circuit test and instead endorsed the policy of flexibility built into chapter 11 of the Bankruptcy Code. It stated:

> The standard adopted by the Court of Appeals for the Second Circuit in *REA Express* is fundamentally at odds with the policies of flexibility and equity built into chapter 11 of the Bankruptcy Code. The rights of workers under collective-bargaining agreements are important, but the *REA Express* standard subordinates the multiple, competing considerations underlying a chapter 11 reorganization to one issue: whether rejection of the collective bargaining agreement is necessary to prevent the debtor from going into liquidation. The evidentiary burden necessary to meet this stringent standard may not be insurmountable, but it will present difficulties to the debtor-in-possession that will interfere with the reorganization process.

Bildisco, 465 U.S. at 525.

Precisely the same objections apply to the rule enunciated by the Seventh Circuit in this case. The decision, like the Second Circuit decision overruled by this Court, is "fundamentally at odds with the policies of flexibility and equity built into chapter 11 of the Bankruptcy Code," and with the principle that "[t]he fundamental purpose of

reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources." *Id.* at 528. The rigid test adopted by the Seventh Circuit deprives the debtor-in-possession of the exercise of its business judgment and substitutes a nearly insurmountable evidentiary burden that impedes, rather than promotes, the reorganization process.

III. THE DECISION OF THE SEVENTH CIRCUIT, IF FOLLOWED, WOULD SERIOUSLY AFFECT THE FEASIBILITY OF REORGANIZATIONS UNDER CHAPTER 11.

Critical vendor orders have become a common and necessary first step toward a successful reorganization. *See Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 574 n.8 (3d Cir. 2003) ("without an order approving financing for critical vendors . . . the debtor might collapse before reorganization can occur"). The debtor seeks to pay certain critical vendors early in the bankruptcy case if, as found by the Bankruptcy Court in this case, those payments are "necessary to keep this business going as a going concern." App. at 66a. Over the past ten years, critical vendor orders have been entered in nearly every major chapter 11 reorganization.

In this case, the Seventh Circuit did not directly abolish critical vendor orders. Instead, it fashioned a new test that is virtually impossible to meet at the beginning of a chapter 11 reorganization, the time when entry of a critical vendor order will be sought. Under the Seventh Circuit's test, a debtor can pay the prepetition claims of its critical vendors at the *beginning* of the case only if the

debtor can show that at the *end* of the case all other prepetition claimants will receive at least as much as they would receive in a chapter 7 liquidation. However, that standard already is a requirement for confirming a plan of reorganization at the end of a case. *See* 11 U.S.C. § 1129(a)(7)(a) (The court shall confirm a plan only if, with respect to each impaired class of claims, "each holder of a claim or interest of such class has accepted the plan; or will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date.").

Under the Seventh Circuit's test, a debtor who has just filed for bankruptcy must scale a wall that the Bankruptcy Code contemplates will not have to be scaled until the debtor is ready to emerge from the protection of chapter 11. Debtors open the bankruptcy door to gain relief and the time necessary to reorganize their affairs. At the beginning of a case, debtors' efforts are focused on obtaining financing and maintaining going concern value while they attempt to restructure their debts. At the beginning of a case, debtors do not have the time or resources to obtain the expert valuations and testimony necessary to establish the liquidation and going concern values required to meet the Seventh Circuit's new test.

The Seventh Circuit has formulated a new standard that cannot be met at the commencement of a case. As a result, the decision of the Seventh Circuit virtually abolishes critical vendor orders and contravenes standard bankruptcy practice, which has promoted flexibility

through the application of the business-justification standard.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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In the
United States Court of Appeals
For the Seventh Circuit

NOS. 03-1956, 03-1999, 03-2000, 03-2001, 03-2035, 03-2262, 03-2346, 03-2347 & 03-2348

In the matter of:

KMART CORPORATION,

Debtor-Appellant

Additional intervening appellants:

KNIGHT-RIDDER, INC.; HANDLEMAN COMPANY; IRVING PULP & PAPER, LIMITED

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.
No. 02 C 1264 *et al.* – **John F. Grady**, *Judge*.

ARGUED JANUARY 22, 2004 – DECIDED FEBRUARY 24, 2004*

Before EASTERBROOK, MANION, and ROVNER, *Circuit Judges*.

EASTERBROOK, *Circuit Judge*. On the first day of its bankruptcy, Kmart sought permission to pay immediately, and in full, the pre-petition claims of all "critical vendors."

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* This opinion is being released in typescript. A printed copy will follow.

(Technically there are 38 debtors: Kmart Corporation plus 37 of its affiliates and subsidiaries. We call them all Kmart.) The theory behind the request is that some suppliers may be unwilling to do business with a customer that is behind in payment, and, if it cannot obtain the merchandise that its own customers have come to expect, a firm such as Kmart may be unable to carry on, injuring all of its creditors. Full payment to critical vendors thus could in principle make even the disfavored creditors better off: they may not be paid in full, but they will receive a greater portion of their claims than they would if the critical vendors cut off supplies and the business shut down. Putting the proposition in this way implies, however, that the debtor must *prove,* and not just allege, two things: that, but for immediate full payment, vendors *would* cease dealing; and that the business will gain enough from continued transactions with the favored vendors to provide some residual benefit to the remaining, disfavored creditors, or at least leave them no worse off.

Bankruptcy Judge Sonderby entered a critical-vendors order just as Kmart proposed it, without notifying any disfavored creditors, without receiving any pertinent evidence (the record contains only some sketchy representations by counsel plus unhelpful testimony by Kmart's CEO, who could not speak for the vendors), and without making any finding of fact that the disfavored creditors would gain or come out even. The bankruptcy court's order declared that the relief Kmart requested – open-ended permission to pay any debt to any vendor it deemed "critical" in the exercise of unilateral discretion, provided that the vendor agreed to furnish goods on "customary trade terms" for the next two years – was "in the best interests of the Debtors, their estates and their creditors".

The order did not explain why, nor did it contain any legal analysis, though it did cite 11 U.S.C. § 105(a). (The bankruptcy court issued two companion orders covering international vendors and liquor vendors. Analysis of all three orders is the same, so we do not mention these two further.)

Kmart used its authority to pay in full the pre-petition debts to 2,330 suppliers, which collectively received about $300 million. This came from the $2 billion in new credit (debtor-in-possession or DIP financing) that the bankruptcy judge authorized, granting the lenders superpriority in post-petition assets and revenues. See *In re Qualitech Steel Corp.*, 276 F.3d 245 (7th Cir. 2001). Another 2,000 or so vendors were not deemed "critical" and were not paid. They and 43,000 additional unsecured creditors eventually received about 10¢ on the dollar, mostly in stock of the reorganized Kmart. Capital Factors, Inc., appealed the critical-vendors order immediately after its entry on January 25, 2002. A little more than 14 months later, after all of the critical vendors had been paid and as Kmart's plan of reorganization was on the verge of approval, District Judge Grady reversed the order authorizing payment. 291 B.R. 818 (N.D. Ill. 2003). He concluded that neither § 105(a) nor a "doctrine of necessity" supports the orders.

Appellants insist that, by the time Judge Grady acted, it was too late. Money had changed hands and, we are told, cannot be refunded. But why not? Reversing preferential transfers is an ordinary feature of bankruptcy practice, often continuing under a confirmed plan of reorganization. See *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290 (7th Cir. 2003). If the orders in question are invalid, then the critical vendors have received preferences

that Kmart is entitled to recoup for the benefit of all creditors. Confirmation of a plan does not stop the administration of the estate, except to the extent that the plan itself so provides. Compare *In re Hovis*, No. 02-2450 (7th Cir. Feb. 2, 2004), with *In re UNR Industries, Inc.*, 20 F.3d 766 (7th Cir. 1994). Several provisions of the Code do forbid revision of transactions completed under judicial auspices. For example, the DIP financing order, issued contemporaneously with the critical-vendors order, is sheltered by 11 U.S.C. § 364(e): "The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal." Nothing comparable anywhere in the Code covers payments made to pre-existing, unsecured creditors, whether or not the debtor calls them "critical." Judges do not invent missing language.

Now it is true that we have recognized the existence of a longstanding doctrine, reflected in *UNR Industries*, that detrimental reliance comparable to the extension of new credit against a promise of security, or the purchase of assets in a foreclosure sale, may make it appropriate for judges to exercise such equitable discretion as they possess in order to protect those reliance interests. See also *In re Envirodyne Industries, Inc.*, 29 F.3d 301, 304 (7th Cir. 1994). Thus once action has been taken to distribute assets under a confirmed plan of reorganization, it would take some extraordinary event to turn back the clock.

These appeals, however, do not question any distribution under Kmart's plan; to the contrary, the plan (which was confirmed after the district court's decision) provides that adversary proceedings will be filed to recover the preferences that the critical vendors have received. No one filed an appeal, which means that it is appellants in this court that now wage a collateral attack on the plan of reorganization.

Appellants say that we should recognize their reliance interests: after the order, they continued selling goods and services to Kmart (doing this was a condition of payment for pre-petition debts). Continued business relations may or may not be a form of reliance (that depends on whether the vendors otherwise would have stopped selling), but they are not *detrimental* reliance. The vendors have been paid in full for post-petition goods and services. If Kmart had become administratively insolvent, and unable to compensate the vendors for post-petition transactions, then it might make sense to permit vendors to retain payments under the critical-vendors order, at least to the extent of the post-petition deficiency. Because Kmart emerged as an operating business, however, no such question arises. The vendors have not established that any reliance interest – let alone any language in the Code – blocks future attempts to recover preferential transfers on account of pre-petition debts.

Handleman Company, which received $49 million as a critical vendor, makes a different procedural objection: that the district court's order does not affect it because Capital Factors' notice of appeal did not name Handleman as an appellee. Handleman was not a "party" in the district court and, consistent with the due process clause of the fifth amendment, cannot be bound by the district

judge's decision – or so it says. We permitted Handleman to intervene in this court. Thus it is a party today and will be bound by *our* decision, so it is hard to see why it matters whether the district judge's resolution would have had independent effect.

Notices of appeal in bankruptcy must name "all parties to the judgment, order, or decree appealed from". Fed. R. Bankr. P. 8001(a)(2). Handleman was not a "party" to the critical-vendors order; Kmart was the sole party at the time. Kmart filed an *ex parte* application that did not specify any particular creditor. It had notified only 65 creditors of its impending request, and none of these was among the 2,000 vendors to be left high and dry. The bankruptcy judge's order likewise did not identify any creditor that acquired rights, for *no* creditor acquired rights. All the order did was authorize Kmart to pay any vendor that Kmart in its discretion deemed "critical." The party that Capital Factors had to name thus was Kmart itself, and this it did. If the lack of personal notice about the proceedings before the district judge deprived Handleman of due process, then Kmart's application to the bankruptcy judge deprived about 47,000 unsecured creditors of due process! That would render the critical-vendors order void, and Handleman would be worse off – for then it would have to repay the money even if the order's entry otherwise would have been lawful. But there is no constitutional obligation to make every creditor a party to every contested matter in the bankruptcy. As a rule, a trustee or debtor in possession represents the interests of many stakeholders. Kmart vigorously represented the interests of Handleman and the other vendors Kmart deemed "critical".

Other creditors must look out for their own interests and intervene if need be – as Handleman could have done had it devoted to these proceedings the care that a $49 million stake warrants. Handleman will be a party, and receive all the notice that the Constitution requires, if Kmart initiates a preference-recovery action against it. As a party in this court, Handleman will not be allowed to contest matters resolved here; even the 2,327 critical vendors that are not parties in this court must accept the precedential effect of our decision. No rule of law requires personal notice to all entities that might be affected by the precedential (as opposed to the preclusive) force of an appellate decision. Today's opinion affects thousands of "critical vendors" and other unsecured creditors; decisions by the Supreme Court may affect millions of persons. Only those persons who will be formally bound by a decision are entitled to individual notice, and then only when practical (the lesson of many a class action, see *Mirfasihi v. Fleet Mortgage Corp.*, No. 03-1069 (7th Cir. Jan. 29, 2004), slip op. 9-10). So there was no flaw in the notice of appeal or the district judge's view that Kmart and Capital Factors were the only parties to the proceedings.

Thus we arrive at the merits. Section 105(a) allows a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the Code. This does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by § 105(a) is one to implement rather than override. See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988); *In re Fesco Plastics Corp.*, 996 F.2d 152, 154 (7th Cir. 1993). Cf. *United States v. Noland*, 517 U.S. 535, 542 (1996). Every circuit that has considered the question has held that this statute does not allow a

bankruptcy judge to authorize full payment of any unsecured debt, unless all unsecured creditors in the class are paid in full. See *In re Oxford Management Inc.*, 4 F.3d 1329 (5th Cir. 1993); *Official Committee of Equity Security Holders v. Mabey*, 832 F.2d 299 (4th Cir. 1987); *In re B&W Enterprises, Inc.*, 713 F.2d 534 (9th Cir. 1983). We agree with this view of § 105. "The fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be." *In re Chicago, Milwaukee, St. Paul & Pacific R.R.*, 791 F.2d 524, 528 (7th Cir. 1986).

A "doctrine of necessity" is just a fancy name for a power to depart from the Code. Although courts in the days before bankruptcy law was codified wielded power to reorder priorities and pay particular creditors in the name of "necessity" – see *Miltenberger v. Logansport Ry.*, 106 U.S. 286 (1882); *Fosdick v. Schall*, 99 U.S. 235 (1878) – today it is the Code rather than the norms of nineteenth century railroad reorganizations that must prevail. *Miltenberger* and *Fosdick* predate the first general effort at codification, the Bankruptcy Act of 1898. Today the Bankruptcy Code of 1978 supplies the rules. Congress did not in terms scuttle old common-law doctrines, because it did not need to; the Act curtailed, and then the Code replaced, the entire apparatus. Answers to contemporary issues must be found within the Code (or legislative halls). Older doctrines may survive as glosses on ambiguous language enacted in 1978 or later, but not as freestanding entitlements to trump the text. See, e.g., *Lamie v. United States Trustee*, No. 02-693 (U.S. Jan. 26, 2004), slip op. 6-7; *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235,

242-46 (1989); *Bethea v. Robert J. Adams & Associates*, 352 F.3d 1125, 1128-29 (7th Cir. 2003). See also *Noland* (courts lack authority to subordinate creditors that judges, as opposed to legislators, believe should be lower in the hierarchy).

So does the Code contain any grant of authority for debtors to prefer some vendors over others? Many sections require equal treatment or specify the details of priority when assets are insufficient to satisfy all claims. E.g., 11 U.S.C. §§ 507, 1122(a), 1123(a)(4). Appellants rely on 11 U.S.C. §§ 363(b), 364(b), and 503 as sources of authority for unequal treatment. Section 364(b) reads: "The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense." This authorizes the debtor to obtain credit (as Kmart did) but has nothing to say about how the money will be disbursed or about priorities among creditors. To the extent that *In re Payless Cashways, Inc.*, 268 B.R. 543 (Bankr. W.D. Mo. 2001), and similar decisions, hold otherwise, they are unpersuasive. Section 503, which deals with administrative expenses, likewise is irrelevant. Pre-filing debts are not administrative expenses; they are the antithesis of administrative expenses. Filing a petition for bankruptcy effectively creates two firms: the debts of the pre-filing entity may be written down so that the post-filing entity may reorganize and continue in business if it has a positive cash flow. See *Boston & Maine Corp. v. Chicago Pacific Corp.*, 785 F.2d 562 (7th Cir. 1986). Treating pre-filing debts as "administrative" claims against the post-filing entity would impair the ability of bankruptcy law to prevent old debts from sinking a viable firm.

That leaves § 363(b)(1): "The trustee [or debtor in possession], after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." This is more promising, for satisfaction of a pre-petition debt in order to keep "critical" supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy. Capital Factors insists that § 363(b)(1) should be limited to the commencement of capital projects, such as building a new plant, rather than payment of old debts – as paying vendors would be "in the ordinary course" but for the intervening bankruptcy petition. To read § 363(b)(1) broadly, Capital Factors observes, would be to allow a judge to rearrange priorities among creditors (which is what a critical-vendors order effectively does), even though the Supreme Court has cautioned against such a step. See *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213 (1996); *Noland, supra.* Yet what these decisions principally say is that priorities do not change unless a statute supports that step; and if § 363(b)(1) is such a statute, then there is no insuperable problem. If the language is too open-ended, that is a problem for the legislature. Nonetheless, it is prudent to read, and use, § 363(b)(1) to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code. We need not decide whether § 363(b)(1) could support payment of some pre-petition debts, because *this* order was unsound no matter how one reads § 363(b)(1).

The foundation of a critical-vendors order is the belief that vendors not paid for prior deliveries will refuse to make new ones. Without merchandise to sell, a retailer such as Kmart will fold. If paying the critical vendors would enable a successful reorganization and make even

the disfavored creditors better off, then all creditors favor payment whether or not they are designated as "critical." This suggests a use of § 363(b)(1) similar to the theory underlying a plan crammed down the throats of an impaired class of creditors: if the impaired class does at least as well as it would have under a Chapter 7 liquidation, then it has no legitimate objection and cannot block the reorganization. See generally *Bank of America v. 203 N. LaSalle St. Partners,* 526 U.S. 434 (1999). For the premise to hold true, however, it is necessary to show not only that the disfavored creditors *will* be as well off with reorganization as with liquidation – a demonstration never attempted in this proceeding – but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued. If vendors will deliver against a promise of current payment, then a reorganization can be achieved, and all unsecured creditors will obtain its benefit, without preferring any of the unsecured creditors.

Some supposedly critical vendors will continue to do business with the debtor because they must. They may, for example, have long term contracts, and the automatic stay prevents these vendors from walking away as long as the debtor pays for new deliveries. See 11 U.S.C. § 362. Fleming Companies, which received the largest critical-vendors payment because it sold Kmart between $70 million and $100 million of groceries and related goods weekly, was one of these. No matter how much Fleming would have liked to dump Kmart, it had no right to do so. It was unnecessary to compensate Fleming for continuing to make deliveries that it was legally required to make. Nor was Fleming likely to walk away even if it had a legal right to do so. Each new delivery produced a profit; as long

as Kmart continued to pay for new product, why would any vendor drop the account? That would be a self-inflicted wound. To abjure new profits because of old debts would be to commit the sunk-cost fallacy; well-managed businesses are unlikely to do this. Firms that disdain current profits because of old losses are unlikely to stay in business. They might as well burn money or drop it into the ocean. Again Fleming illustrates the point. When Kmart stopped buying its products after the contract expired, Fleming collapsed (Kmart had accounted for more than 50% of its business) and filed its own bankruptcy petition. Fleming was hardly likely to have quit selling of its own volition, only to expire the sooner.

Doubtless many suppliers fear the prospect of throwing good money after bad. It therefore may be vital to assure them that a debtor will pay for new deliveries on a current basis. Providing that assurance need not, however, entail payment for pre-petition transactions. Kmart could have paid cash or its equivalent. (Kmart's CEO told the bankruptcy judge that COD arrangements were not part of Kmart's business plan, as if a litigant's druthers could override the rights of third parties.) Cash on the barrelhead was not the most convenient way, however. Kmart secured a $2 billion line of credit when it entered bankruptcy. Some of that credit could have been used to assure vendors that payment would be forthcoming for all post-petition transactions. The easiest way to do that would have been to put some of the $2 billion behind a standby letter of credit on which the bankruptcy judge could authorize unpaid vendors to draw. That would not have changed the terms on which Kmart and any of its vendors did business; it just would have demonstrated the certainty of payment. If lenders are unwilling to issue such a

letter of credit (or if they insist on a letter's short duration), that would be a compelling market signal that reorganization is a poor prospect and that the debtor should be liquidated post haste.

Yet the bankruptcy court did not explore the possibility of using a letter of credit to assure vendors of payment. The court did not find that any firm would have ceased doing business with Kmart if not paid for pre-petition deliveries, and the scant record would not have supported such a finding had one been made. The court did not find that discrimination among unsecured creditors was the only way to facilitate a reorganization. It did not find that the disfavored creditors were at least as well off as they would have been had the critical-vendors order not been entered. For all the millions at stake, this proceeding looks much like the Chapter 13 reorganization that produced *In re Crawford,* 324 F.3d 539 (7th Cir. 2003). Crawford had wanted to classify his creditors in a way that would enable him to pay off those debts that would not be discharged, while stiffing the creditors whose debts were dischargeable. We replied that even though classification (and thus unequal treatment) is possible for Chapter 13 proceedings, see 11 U.S.C. § 1322(b), the step would be proper only when the record shows that the classification would produce some benefit for the disfavored creditors. Just so here. Even if § 362(b)(1) allows critical-vendors orders in principle, preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors. This record does not, so the critical-vendors order cannot stand.

AFFIRMED.

(291 B.R. 818)

UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS,
EASTERN DIVISION

CAPITAL FACTORS, INC.,

Appellant,

-v.

KMART CORPORATION

Appellee.

No. 02 C 1264 (consolidated with 02 C 1265, 02 C 2086, 02 C 2088)

April 8, 2003, Decided
April 10, 2003, Docketed

John F. Grady, United States District Judge.

MEMORANDUM OPINION

Capital Factors, Inc. appeals from four final orders of the bankruptcy court that authorized Kmart to pay certain prepetition obligations. For the reasons explained below, the bankruptcy court's orders are reversed.

BACKGROUND

On January 22, 2002, Kmart Corporation and certain of its domestic subsidiaries and affiliates, debtors and debtors-in-possession (collectively, "Kmart") filed a voluntary petition for reorganization pursuant to Chapter 11 of the United States Bankruptcy Code. As part of its "first day motions" filed on that date, Kmart sought authority to pay prepetition obligations to certain "critical vendors" (the "Critical Vendors Motion") and certain foreign vendors

(the "Foreign Vendors Motion"). Kmart contended that these payments were necessary to maintain relationships essential to its continued operation and reorganization, and it invoked the "doctrine of necessity" and 11 U.S.C. § 105(a) for the bankruptcy court's authority to permit these payments.

The same day, the bankruptcy court held a hearing and heard evidence on these motions. Appellant Capital Factors, Inc. ("Capital") objected to both motions. (Capital is a factoring agent[1] for a number of Kmart's apparel suppliers, and it holds general unsecured claims against the bankruptcy estate of approximately $20 million.)

Regarding the Critical Vendors Motion, the court stated:

> Motions to pay certain critical trade creditors always present difficult questions for courts. We're seeing more and more of them, and our problem is that we have to stretch to find some authority to do them. However, I, after hearing this testimony and reading the affidavit [of Charles C. Conaway, Kmart's Chief Executive Officer], am convinced that Fleming, Handleman and the egg and dairy vendors – and I would like a list of the specific vendors that you would like included in this motion – as well as the advertising concerns, are necessary to keep this business going as a going concern.

(App. to Appellee's Brief, Ex. 4A, at 162.) Accordingly, the bankruptcy court granted the Critical Vendors Motion.

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[1] A factoring agent purchases accounts receivable from its customers and assumes the collection responsibilities. *See Mr. Furniture Warehouse, Inc. v. Barclays Am./Commercial Inc.*, 919 F.2d 1517, 1519 (11th Cir. 1990).

Without reciting specific findings from the bench, the bankruptcy court also granted the Foreign Vendors Motion. (*Id.* at 173.) On January 25, the bankruptcy court entered written orders granting both motions.

On February 1 and 8, 2002, Kmart filed motions seeking authority to pay issuers of prepetition letters of credit (the "Letters of Credit Motion") and prepetition claims of certain liquor vendors (the "Liquor Vendors Motion"). On February 13, the bankruptcy court held a hearing on these motions, heard evidence, and granted both motions over Capital's objections. Regarding the Letters of Credit Motion, the court stated:

> Because the foreign vendors are integral to the reorganization of this Debtor and the Court already ruled on the payment of certain foreign vendors as part of the critical vendors motions and I believe that this is just a component of that particular transaction, and further finding that I may be inconsistent if I do not grant the relief that is requested here, I am going to go ahead and sign your order authorizing the reimbursement of the obligations to the issuers of Letters of Credit.

(*Id.*, Ex. 4B, at 251.) The bankruptcy court also granted the Liquor Vendors motion, "finding that there [was] a good business justification for it." (*Id.* at 269.) Written orders granting the motions were entered that same day.

Capital filed notices of appeal from each order, and we granted Capital's motion to consolidate the appeals. The parties' briefing is complete, and we heard oral argument on the appeals as well.

DISCUSSION

This court has jurisdiction over the instant appeals pursuant to 28 U.S.C. § 158(a)(1). On appeal from an order of the bankruptcy court, we review the bankruptcy court's factual findings under a "clearly erroneous" standard and its conclusions of law de novo. *See In re Smith,* 286 F.3d 461, 464-65 (7th Cir. 2002); Fed. R. Bankr. P. 8013.

Capital raises the following issues on appeal: (1) whether 11 U.S.C. § 105(a) or the "doctrine of necessity" provides a bankruptcy court with either statutory authority or equitable power to allow the payment of selected prepetition unsecured trade claims prior to confirmation of a Chapter 11 plan[2]; (2) whether there was a sufficient evidentiary basis for the bankruptcy court to allow payment of certain prepetition claims; and (3) whether state laws prohibiting liquor wholesalers from selling products to Chapter 11 debtors legally unable to pay their prepetition debt are invalid or unenforceable to the extent that they conflict with the Bankruptcy Code.[3] Kmart raises the additional issue of whether Capital's appeals are moot because Kmart has already paid a substantial portion of the prepetition claims.

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[2] For convenience, we will refer to the time period prior to confirmation of a Chapter 11 plan as "pre-plan."

[3] Capital also raises what it deems a separate issue of whether "a bankruptcy court may utilize" § 105(a) or the "doctrine of necessity" "to circumvent explicit provisions of the Bankruptcy Code." (Appellant's Brief at 2.) We view this issue as being part and parcel of the first issue listed *supra.*

A. The Bankruptcy Court's Power Under § 105

We first examine the question of whether the bankruptcy court had the power to authorize the pre-plan payment of prepetition claims. The court relied on 11 U.S.C. § 105(a) to authorize the payments. Section 105(a) addresses the equitable powers of bankruptcy courts and provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105(a). Although the bankruptcy court did not refer specifically to the equitable "doctrine of necessity" when ruling on the motions in open court or in its written orders,[4] Kmart relies on the doctrine. It is derived from the "necessity of payment rule," which was developed and used in railroad reorganizations "as justification for the payment of pre-petition debts paid under duress to secure continued supplies or services essential to the continued operation of the railroad." *B & W Enters., Inc. v. Goodman Oil Co. (In re B & W Enters., Inc.)*, 713 F.2d 534, 537 (9th Cir. 1983). The rule has subsequently evolved into the "doctrine of necessity," which has been applied in non-railroad reorganizations to justify the pre-plan payment of prepetition claims of creditors who threaten to withhold

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[4] As noted *supra*, the bankruptcy court did, however, find that the payments were "necessary," "integral," and that there was "good business justification" for them.

goods or services believed critical to the debtor's continued viability and reorganization.[5] The doctrine is not codified anywhere in the Bankruptcy Code, so the only way to apply it is through § 105.

The Seventh Circuit has stated that the grant of equitable power in § 105 is limited in that it "allows [bankruptcy] Courts to use their equitable powers only as necessary to enforce the provisions of the Code, not to add on to the Code as they see fit." *In re Fesco Plastics Corp.*, 996 F.2d 152, 156 (7th Cir. 1993); *see also Gouveia v. Tazbir,* 37 F.3d 295, 300 (7th Cir. 1994) ("The Supreme Court has taught that any grant of authority given to the bankruptcy courts under § 105 must be exercised within the confines of the bankruptcy code.") (citing *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197, 99 L. Ed. 2d 169, 108 S. Ct. 963 (1988)).

The Bankruptcy Code sets forth a priority scheme for the payment of claims. *See* 11 U.S.C. §§ 503, 507. The Code does not carve out priority or administrative expense status for prepetition general unsecured claims based on the "critical" or "integral" status of a creditor. But the effect of the bankruptcy court's orders was to elevate the claims of the "critical" vendors over those of other unsecured creditors and to subordinate the claims of non-"critical" unsecured creditors. The bankruptcy court altered the priority scheme set forth in the Bankruptcy Code.

There is a split in the courts regarding whether § 105 authorizes bankruptcy courts to permit pre-plan payment of prepetition unsecured claims. As set forth in Kmart's

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[5] See 2 William L. Norton, Jr., *Norton Bankr. L. & Prac. 2d* § 42:11 (Supp. 2002), for a good discussion of the doctrine's history.

briefs, many bankruptcy courts and a handful of district courts have held that bankruptcy courts do in fact have this power. *See, e.g., In re Just For Feet, Inc.*, 242 B.R. 821 (D. Del. 1999); *Michigan Bureau of Workers' Disability Comp. v. Chateaugay Corp. (In re Chateaugay Corp.)*, 80 B.R. 279 (S.D.N.Y. 1987); *In re CoServ, L.L.C.*, 273 B.R. 487 (Bankr. N.D. Tex. 2002); *In re Wehrenberg, Inc.*, 260 B.R. 468 (Bankr. E.D. Mo. 2001).

On the other hand, as Capital points out, a number of courts of appeals and a few lower courts have held just the opposite. *See, e.g., Official Comm. of Equity Sec. Holders v. Mabey*, 832 F.2d 299 (4th Cir. 1987); *B & W Enters., Inc. v. Goodman Oil Co. (In re B & W Enters., Inc.)*, 713 F.2d 534 (9th Cir. 1983); *Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Mgmt. Inc.)*, 4 F.3d 1329 (5th Cir. 1993); *In re FCX, Inc.*, 60 B.R. 405 (E.D.N.C. 1986); *In re Timberhouse Post & Beam, Ltd.*, 196 B.R. 547 (Bankr. D. Mont. 1996).[6] We agree with the latter courts' view that we cannot ignore the Bankruptcy Code's statutory scheme of priority in favor of "equity," especially in light of the Seventh Circuit's admonition that "the fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views

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[6] *Cf. Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.)*, 963 F.2d 1490 (11th Cir. 1992) (bankruptcy court had no authority to allow cross-collaterization, a method of securing prepetition debt with prepetition and postpetition collateral); *Southern Ry. Co. v. Johnson Bronze Co. (In re Johnson Bronze Co.)*, 758 F.2d 138 (3d Cir. 1985) (bankruptcy court had no authority to grant lien status to a prepetition contractual indemnification claim); *Crowe & Assocs., Inc. v. Bricklayers & Masons Union Local No. 2 (In re Crowe & Assocs., Inc.)*, 713 F.2d 211, 216 (6th Cir. 1983) (dictum).

may be." *In re Chicago, Milwaukee, St. Paul & Pac. R.R. Co.*, 791 F.2d 524, 528 (7th Cir. 1986).

We acknowledge that the application of the "doctrine of necessity" through § 105 in this situation is well-intended and may even have some beneficial results, in that pre-plan payment of certain prepetition claims allows the debtor to minimize disruptions in doing business, and thus may further reorganization. Nevertheless, it is clear that however useful and practical these payments may appear to bankruptcy courts, they simply are not authorized by the Bankruptcy Code. Congress has not elected to codify the doctrine of necessity or otherwise permit pre-plan payment of prepetition unsecured claims.

Because we hold that the bankruptcy court did not have either the statutory or equitable power to authorize the pre-plan payment of prepetition unsecured claims, we need not address the second and third issues Capital raises on appeal.

B. "Equitable Mootness"

Kmart does not persuade us that Capital's appeals are moot due to the fact that the prepetition claims have been substantially paid. Kmart makes much of the fact that Capital did not seek a stay of the bankruptcy court's orders. It is highly unlikely, however, that a motion to stay would have been successful. It would be inconsistent for the bankruptcy court to enter the orders on the theory that prompt payments were necessary to keep Kmart operational, and then turn around and stay those orders.[7]

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[7] See Charles Jordan Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 Am. Bankr. L.J. 75, 108 (1991).

In any event, Capital was not required to seek a stay of the orders in order to preserve its appellate rights.

Kmart also argues that the appeals are "equitably moot" because effective relief on appeal has become imprudent and inequitable. The term "equitable mootness" was "anathematized by Judge Easterbrook"[8] in the case of *In re UNR Industries, Inc.*, 20 F.3d 766, 768 (7th Cir. 1994). The Seventh Circuit in *UNR* "banished the term 'equitable mootness' from the (local) lexicon," 20 F.3d at 769, because it is misleading: "there is a big difference between inability to alter the outcome (real mootness) and unwillingness to alter the outcome ('equitable mootness')." *Id.* Nonetheless, the "now nameless doctrine" lives on and "is perhaps best described as merely an application of the age-old principle that in formulating equitable relief a court must consider the effects of the relief on innocent third parties." *Envirodyne,* 29 F.3d 301 at 304. The basic questions under the doctrine, then, are these: is it prudent and fair to undo what the bankruptcy court did?[9] *See UNR,* 20 F.3d at 769; *Envirodyne,* 29 F.3d at 304.

Kmart argues that we should not reverse the orders allowing payment of the prepetition claims because the parties receiving the payments have already acted in reliance on them. As noted supra note 9, however, this is not a situation where there has been confirmation of a

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[8] *In re Envirodyne Indus., Inc.*, 29 F.3d 301, 304 (7th Cir. 1994).

[9] As Capital points out, it is worth noting that most of the cases addressing or applying the doctrine involved appeals of orders confirming bankruptcy plans of reorganization. *See, e.g., UNR,* 20 F.3d 766; *Mac Panel Co. v. Virginia Panel Corp.*, 283 F.3d 622 (4th Cir. 2002). Those cases are distinguishable from the instant proceeding because there has not yet been a confirmation of Kmart's plan.

bankruptcy plan. Accordingly, it is not too late to order that the monies paid be returned. Kmart also claims that undoing the bankruptcy court's orders would "paralyze" Kmart by forcing it to "undergo the Herculean task of immediately commencing thousands of lawsuits to collect hundreds of millions of dollars from thousands of vendors." (Appellee's Brief at 45-46.) We are not persuaded by Kmart's doomsday speculations. It is not evident that Kmart will have to sue to recover the payments, and in fact, Kmart cites no cases indicating that the bankruptcy court would not have the power to order the return of the monies paid.

C. J.P. Morgan Chase's Brief

J.P. Morgan Chase ("JPM"), which is an "administrative agent for the lenders under various pre-petition credit agreements among such lenders and Kmart" (JPM Brief at 1), has filed a supplemental brief regarding the Letters of Credit Motion. JPM contends that, even if the bankruptcy court did not have the authority under § 105 to authorize Kmart to pay the prepetition claims of the issuers of the letters of credit, the court "properly allowed those payments [pursuant to § 361 of the Bankruptcy Code] on the basis that such payments constituted adequate protection for the Issuers' secured reimbursement claims under the Letters of Credit." (JPM Brief at 2.) According to JPM, the issuers had statutory liens in the documents and the proceeds thereof presented by the foreign vendors to obtain payment under the letters of credit, and the issuers

were entitled to adequate protection of those liens under § 361 of the Code.[10]

In authorizing the payments to the issuers of the letters of credit, the bankruptcy court did not rely on § 361. We may affirm the bankruptcy court's decision on an alternative ground, but that ground must have been adequately presented in the bankruptcy court. *See Anderson v. U.S.F. Logistics (IMC), Inc.*, 274 F.3d 470, 478 (7th Cir. 2001) (citing *Logan v. Caterpillar, Inc.*, 246 F.3d 912, 924 (7th Cir. 2001)). Neither Kmart nor the issuers raised the adequate protection issue at the hearing on the Letters of Credit Motion. The bankruptcy court was not presented with evidence on whether the issuers held valid security interests nor whether they were entitled to adequate protection. There is an insufficient basis in the record to allow a finding that the payments to the issuers

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[10] Section 361 provides:

> When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by –
>
> 1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;
>
> 2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or
>
> 3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

constituted adequate protection under § 361 of the Bankruptcy Code.

CONCLUSION

For the foregoing reasons, the following orders of the bankruptcy court are reversed: (1) Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Critical Trade Vendors; (2) Order Pursuant to 11 U.S.C. §§ 105(a) and 363 Authorizing Payment of Prepetition Obligations Necessary to Obtain Imported Merchandise; (3) Order Pursuant to 11 U.S.C. §§ 105(a) and 363 Authorizing the Debtors to Honor Reimbursement Obligations to Issuers of Pre-Petition Letters of Credit Issued for the Benefit of the Debtors' Foreign Vendors; and (4) Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Liquor Vendors.

The case is remanded for further proceedings consistent with this opinion.

DATE: April 8, 2003

ENTER: John F. Grady, United States District Judge

Docket Entry No. 37 (in No. 02-1264)

For the foregoing reasons, the following orders of the bankruptcy court are reversed: (1) Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Critical Trade Vendors; (2) Order Pursuant to 11 U.S.C. §§ 105(a) and 363 Authorizing Payment of Prepetition Obligations Necessary to Obtain Imported Merchandise; (3) Order Pursuant to 11 U.S.C. §§ 105(a) and 363

Authorizing the Debtors to Honor Reimbursement Obligations to Issuers of Pre-Petition Letters of Credit Issued for the Benefit of the Debtors' Foreign Vendors; and (4) Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Liquor Vendors. The case is remanded for further proceedings consistent with this opinion.

Appellant's motion for an expedited ruling is denied as moot.

IN THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS EASTERN DIVISION

In re:	) Case No. 02-B02474
	) (Jointly Administered)
KMART CORPORATION, *et al.*,	) Chapter 11
Debtors.	) Chief Judge Susan
	) Pierson Sonderby

ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS

Upon the motion dated January 22, 2002 (the "Motion"), wherein Kmart Corporation ("Kmart") and certain of its domestic subsidiaries and affiliates, debtors and debtors-in-possession in the above-captioned cases (collectively, the "debtors" or the "Company"), moved this Court for entry of an order, pursuant to section 105(a) authorizing the Debtors to pay Critical Vendor Claims; it appearing to the Court that (i) it has jurisdiction over the matters raised in the Motion pursuant to 28 U.S.C. §§ 157 and 1334; (ii) this is a core proceeding pursuant to 28 U.S.C. § 157(b)(2); (iii) the relief requested in the Motion is in the best interests of the Debtors, their estates and their creditors; (iv) proper and adequate notice of the Motion and the hearing thereon has been given and that no other or further notice is necessary; and (v) upon the record herein, including the exhibits attached to the Notice of Filing of Exhibits as Ordered by the Court at the January 22, 2002 Hearing, filed on or about January 25, 2002, after

due deliberation thereon, the relief should be granted as set forth below,

1. The Debtors are authorized, but not directed, in the reasonable exercise of their business judgment, to pay all, a portion or none of the prepetition claims (the "Critical Vendor Claims") of the following "Critical Vendors": (a) Fleming Companies, Inc.; (b) Handleman Company; (c) vendors who supply egg and dairy and (d) certain newspapers, printers, paper suppliers and other vendors who supply goods and services related to the Debtors' advertising program. The payment of the Critical Vendor Claims shall not exceed those set forth in the Motion upon such terms and in the manner provided in this Order and subject to the provisions of the Debtors' postpetition financing agreement.

2. Any checks used by the Debtors to pay Critical Vendor Claims shall contain a legend substantially in the following form:

> By accepting this check, the payee agrees to the terms of that certain Order of the United States Bankruptcy Court for the Northern District of Illinois, dated as of ___, in the payor's chapter 11 case (Case No. ___), entitled "Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Critical Trade Vendors," (including, if applicable, any Trade Agreement entered into pursuant to that Order) and submits to the jurisdiction of that Court for enforcement thereof.

3. The Debtors shall undertake appropriate efforts to cause Critical Vendors to enter into an agreement with the Debtors as provided herein as a condition of payment of

their Critical Vendor Claims, which agreement shall include the following terms:

(a) The amount of such Critical Vendor's estimated Critical Vendor Claims, accounting for any setoffs, other credits and discounts thereto, shall be as mutually determined in good faith by the Critical Vendor and the Debtors (but such amount shall be used only for the purposes of determining such Critical Vendor's claim under this Order and shall not be deemed a claim allowed by the Court and the rights of all interested persons to object to such claim shall be fully preserved until further order of this Court);

(b) The Customary Trade Terms between such Critical Vendor and the Debtors, or such other terms as the Critical Vendors and the Debtors may agree;

(c) The Critical Vendor's agreement to provide goods and services to the Debtors based upon Customary Trade Terms or on such other favorable terms as the Debtors and the Critical Vendor may otherwise agree for a period at least two (2) years from the Petition Date, and the Debtors' agreement to pay in accordance with such terms;

(d) The Critical Vendor's agreement not to file or otherwise assert against any or all of the Debtors, their estates or any other person or entity or any of their respective assets or property (real or personal) any lien (a "Lien"), regardless of the statute or other legal authority upon which such Lien is asserted, related in any way to any remaining prepetition amounts allegedly owed to the Critical Vendor by the Debtors arising from agreements or other arrangements entered into prior to the Petition Date, and, to the extent the Critical Vendor has already

obtained or otherwise asserted such a Lien, the Critical Vendor shall take whatever actions are necessary to remove such Lien;

(e) The Critical Vendor's acknowledgment that is [sic] has reviewed the terms and provisions of this Order and consents to be bound hereby; and

(f) The Critical Vendor's agreement that it will not separately seek payment for reclamation claims outside the terms of this Order unless the Critical Vendor's participation in the program to pay Critical Vendor Claims pursuant to this Order is terminated; *privided, however,* that such reclamation claims shall, if thereafter raised by the Critical Vendor as permitted by this Order, be treated as though raised on the date of this Order.

An agreement executed by and between the Debtors and a Critical Vendor as set forth in this paragraph shall be referred to as a "Trade Agreement." This order is intended to authorize, but shall not require, the Debtors to enter into Trade Agreements, it being the express intention of this Court that the Debtors shall enter into Trade Agreements only when the Debtors determine, in the exercise of their reasonable business judgment, that it is appropriate to do so.

4. The Debtors are authorized, in their discretion to make payments on account of Critical Vendor Claims in the absence of a Trade Agreement after the Debtors have undertaken diligent efforts to cause the Critical Vendor holding such Critical Vendor Claim to execute a Trade Agreement and if the Debtors determine, in their business judgment, that failure to pay the Critical Vendor Claim is likely to result in irreparable harm to the Debtors' business operations.

5. If a Critical Vendor refuses to supply goods and/or services to the Debtors on Customary Trade Terms following receipt of payment on its Critical Vendor Claim, or fails to comply with any Trade Agreement entered into between such Critical Vendor and the Debtors, then the Debtors may, in their discretion and without further order of the Court, (a) declare that any Trade Agreement between the Debtors and such Critical Vendor is terminated (if applicable), and (b) declare that provisional payments made to Critical Vendors on account of Critical Vendor Claims be deemed to have been in payment of then-outstanding post-petition claims of such vendors without further order of the Court or action by any person or entity, and, to the extent that payments on account of such Critical Vendor Claims exceed the postpetition claims of such vendors then outstanding without giving effect to any rights of setoff, claims, provision for payment of reclamation or trust fund claims, or otherwise. In the event a Trade Agreement is terminated or a Critical Vendor refuses to supply goods and/or services to the Debtors on Customary Trade Terms following receipt of payment on its Critical Vendor Claim, it is the explicit intention of this Court to return the parties to their position immediately prior to the entry of the order approving this Motion with respect to all prepetition claims.

6. The Debtors may, in their sole discretion, reinstate a Trade Agreement if:

(a) Such determination is subsequently reversed by the Court, after notice and a hearing following a motion by the Critical Vendor, for good cause shown that the determination was materially incorrect;

(b) The underlying default under the Trade Agreement was fully cured by the Critical Vendor not later than five (5) business days following the Debtors' notification to the Critical Vendor that a default had occurred; or

(c) The Debtors, in their discretion, reach a favorable alternative agreement with the Critical Vendor.

7. Nothing herein shall be construed to limit, or in any way affect, the Debtors' ability to dispute any Critical Vendor Claim.

8. Nothing contained in this order shall be deemed to constitute an assumption or rejection of any executory contract or agreement between the Debtors and a Critical Vendor or to require the Debtors to make any of the payments authorized herein.

9. Notwithstanding the relief granted herein and any actions taken hereunder, nothing contained herein shall create, nor is it intended to create, any rights in favor of, or enhance the status of any claim held by, any person.

10. This Court shall retain jurisdiction to construe and enforce this Order.

Dated: Chicago, Illinois
January 25, 2002

/s/ Susan Pierson Sonderby
Chief Judge Susan Pierson Sonderby
UNITED STATES BANKRUPTCY JUDGE

IN THE UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

KMART CORPORATION,	) No. 02-B 02474
Debtors.	) JANUARY 22, 2002
	) 4:00 P.M.
	) Chicago, Illinois

TRANSCRIPT OF PROCEEDINGS BEFORE
THE HONORABLE SUSAN PIERSON SONDERBY

APPEARANCES:

For the Debtor:	Mr. Jack Butler; Mr. Eric Ivester;
For the U.S. Trustee:	Ms. Kathryn Gleason;
For Footstar, Inc.:	Mr. David Cleary;
For Cardinal:	Mr. Ronald R. Peterson;
For Penske and Sara Lee:	Mr. David Missner;
For Ramco Gershenson, New Plan Excel Realty Trust, the Rouse Company Affiliates:	Ms. Synde Keywell;
For G E Capital:	Mr. Sheldon Solow; Mr. Gary Holtzer;
For Disney:	Ms. Deborah Thorne;
For Comerica:	Mr. Kurt Carlson
For Fleming:	Mr. John Delnero

[2] APPEARANCES (Continued):

For Capital Factors:	Mr. Steven Towbin;

For VS Food Service:	Mr. Clinton Hansen;
For the SEC:	Ms. Angela Dodd;
For JP Morgan Chase:	Mr. Jeffrey Marwil; Mr. Brian Graham; Mr. Robert Scheibe; Mr. Jay Teitelbaum;
For Various Unsecured Creditors:	Mr. Randall Klein;
For Knight Ridder:	Mr. Joseph Frank;
Court Rep order:	Amy B. Doolin, CSR, RPR U.S. Courthouse 219 South Dearborn Chicago, Illinois 60604

[3] KMART CORPORATION
02 B 2474
January 22, 2002

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Witness:	DX	CX	RDX	RCX
Charles Conaway	139	154		

[4] THE CLERK: Now taking up Kmart Corporation, 02 B 2474.

MR. BUTLER: Your Honor, good afternoon. Jack Butler again from Skadden, Arps, Slate, Meagher & Flom, Illinois, on behalf of the debtors for the first day hearing for Kmart Corporation and 37 of its affiliate debtors.

Your Honor, from a procedural perspective this afternoon, with your permission, there has been – the clerk of court has already had us fill out an appearance list

to avoid having to give individual appearances, and we were going to let everyone remain seated unless they wanted to actually address the court.

THE COURT: That will be acceptable.

MR. BUTLER: Thank you, Your Honor. Your Honor, we've also circulated, prepared and circulated and noticed a proposed first day agenda.

THE COURT: Before you go further, although we had you sign up, I wonder if those appearances are part of the record, and perhaps we should take appearances so that they will be part of the record.

MR. BUTLER: Your Honor, do you want to have the appearance list filed with the record or do you want to take them individually?

THE COURT: Where is the appearance list?

* * *

[125] would shift back to the debtor and I suppose my client would have to establish a doctrine of necessity basis for the granting of this motion.

MR. IVESTER: And the debtor has made the business judgment that in light of the ramifications to it, the effects on its balance sheet, the effects on the goods on its shelf from this uncertainty, that they're going to take care of this uncertainty. If need be, we can have the chief executive officer of the company take the stand and tell about the demands and the threats that he's had, because he's itching to do it to take goods of the shelves. And so the debtor wants no uncertainty about its consignment program.

THE COURT: All right. What I'm am going to do is I'm going to enter the relief that's requested by the debtor but I am also going to preserve the rights of the creditors committee to challenge the extent and validity of the consignment claims. Will you put that language into the order.

I have a couple of other questions. On page two you're asking that the debtors are authorized in their sole discretion to accept consigned goods. What does sole discretion add? What does that mean?

MR. IVESTER: I think they probably have at their sole discretion to accept consigned goods anyway, [126] so maybe that's gratuitous.

THE COURT: All right. Why don't you take that out.

Also on page 4 in paragraph 8 it talks about the banks and financial –

MR. IVESTER: I'm sorry, Your Honor.

THE COURT: Paragraph 8 on page 4 it talks about the banks and other financial institutions authorized to direct, et cetera, evidencing amounts paid to the debtor – paid by the debtors pursuant to the motion. I would like you to be a little bit more specific as to this consignment motion so that there is no question.

MR. IVESTER: Yes, Your Honor.

THE COURT: In paragraph 10 I would like you to serve the banks also with a copy of the order on each of the consignment vendors for accepting payments by the debtor.

Did I hear the U.S. Trustee on this motion?

MS. GLEASON: Your Honor, we believe that it is the debtors' business judgment. We have no grounds to challenge it.

THE COURT: All right.

MR. PETERSON: Your Honor, could we have some type of deadline so that we have finality in our life?

[127] Perhaps 60 days after the counsel for the creditors committee is appointed they have to file this 9023 motion.

THE COURT: I think that's a good suggestion because this is not an interim order, so a 60-day time limit after the creditors committee is appointed.

All right. Now we're going to get to the critical trade vendors and payment of them.

MR. PETERSON: Thank you, Judge.

MR. IVESTER: The next item on the agenda is the motion under Section 105 authorizing payment of prepetition claims to certain critical trade vendors. You know, unlike a lot of cases, Your Honor, this motion is not a broad program. We have tried to identify those parties who we truly think are critical trade vendors, vendors without whom the debtors would severely hamper their business operations.

For instance, I don't know if you had a chance to read some of the reports that were coming out in recent days with our food distribution company, Fleming Companies, which are headquartered in Dallas. Fleming is the debtors' single largest supplier, accounting for 11 percent or 4.2 billion total sales by the debtors on an annual basis.

Fleming not only supplies the debtors with merchandise, but it also [128] provides the infrastructure for the debtors' food and consumable operations, including buying and procuring merchandise, warehouse operations, transportation, and logistics, vendor allowance collection management.

As we set forth in the affidavit filed by Mr. Conaway, the impact of cessation by Fleming is grave to this company. Some of our better business and some of the way we get traffic in our stores is through our food and perishable offerings. To have those taken from us could be devastating to this company. The debtors estimate that as of the petition date they owe to Fleming approximately $76 million. We've got some others here, but we do have people appearing on that issue. So if Your Honor, please, maybe I could be quiet and we could hear from others on the Fleming issue.

THE COURT: Well, before we get to that, it occurs to me that these types of payments to these what you deem critical trade vendors will only prompt once the word gets out others to come forward and say they too are critical trade vendors and should be paid for their prepetition goods.

MR. IVESTER: Your Honor, that's the very reason we didn't do a blanket program asking for a wide range of authority to sprinkle those dollars on people we thought was best. We have identified these two [129] entities and two other groups who are truly critical to our success who we cannot suffer the loss of their services to this company. And so just to avoid the very concern you have, we did not implement a larger trade vendor program. We want to be clear, we have identified these four

groups, and these are the people that we believe are critical trade vendors.

THE COURT: Well, it looks like food vendors and then advertising. Then how did music come in there?

MR. IVESTER: Your Honor, they account – Handleman is our sole music vendor, our sole source supplier that you would see in a manufacturing critical trade vendor motion. They account for 15 or $500 million in total sales of the debtors on an annual basis. They not only supply the merchandise but they supply the infra structure for the debtors' music business.

THE COURT: Well, why are they different than any other sole vendor?

MR. IVESTER: I think the debtors believe, both with Fleming – not only are they critical to our business, but we are critical to theirs. And the debtors believe that we may indeed lose their services if they are not paid for their prepetition claim, and so we can't afford to take that risk. Maybe we can with [130] other people out there, but these are the parties that are crucial to the success of this organization, this company, on a go-forward basis. So I think by pointing out how, you know, this covers just a limited amount of entities, that is exemplative of how seriously the debtors have taken this and tried to limit the relief requested to those parties whose services without which we would be in dire straits.

THE COURT: Mr. Frank.

MR. FRANK: Your Honor, I represent Knight Ridder Corporation which is the second largest newspaper chain in the country. Kmart advertises in all 31 of Knight Ridder's newspapers. We own newspapers in Philadelphia,

Dallas-Fort Worth, Detroit, as well as many other major cities. I'm simply here to support the motion. I agree, of course, that we are critical, and there is no replacement for what we provide. To the extent that there is specific opposition, I will address it, Your Honor.

MR. DELNERO: Your Honor, my name is John Delnero. I represent Fleming. There are a couple of unique aspects of the relationship with Fleming that I believe really mitigate in favor of granting of the debtors' motion.

As the debtor said, it is obviously critical [131] to their business. We supply, as I understand it, a hundred percent of what are called consumables, nonedible products, paper towels, detergent, things like that, a hundred percent. We also supply a hundred percent of certain types of food products. Now obviously we are a major part of their business. They are also a major part of our business.

The fact of the matter is that we sell between 70 and $100 million a week in product to the debtor. Now, the debtor is proposing to pay us $76 million. I don't know at this point standing here whether that's an accurate number but its certainly within the range of the weekly sales dollars.

Now, just to sort of cut to the chase and address what I believe Mr. Towbin is going to raise, it is my understanding that most, if not all of the products that are covered within that $76 million amount, would have been delivered within the approximate ten days before bankruptcy, so they would be subject to rights of reclamation in any event. We also have an even more important reason to have this motion granted on a permanent basis, and that it that my client needs to make a decision, I believe tomorrow – my understanding is that they deliver

on a Wednesday to Wednesday basis before – they to [sic] need make that [132] decision tomorrow. And we are still facing some risks even if this order is entered, because it's my understanding that the payments that are going to be made to us will not be made until the earliest this Friday. We are looking at increasing our exposure from $76 million to as much as $176 million. It's critical to us. It's critical to them. And we believe that the motion has to be granted certainly with respect to our piece.

THE COURT: But I would assume that you do want to see this debtor continue on and you do want to sell to the debtor?

MR. DELNERO: Absolutely. We sure do, but we also have to be cognizant of an enormous increase in the exposure of our risk from, as I said, 76 million to as much as 176 million.

MR. MISSNER: Your Honor, David Missner on behalf of Penske Auto and Sara Lee. As I read the motion, I don't know if Mr. Ivester mentioned that there is – I think the max is a couple hundred million dollars, which in the context of this case is a lot of money, but it's not really a lot –

THE COURT: But it's precedent.

MR. MISSNER: Well, I'm going to get to that. The order also provides for certain additional [133] requirements regarding the extension of credit, as I understand it and I didn't – I didn't write the motion, of course, but as I understand it, the motion requires basically certain additional requirements from the vendors, not just merely payments. They have to provide some credit terms

and there are other things that they have to do in order to get paid.

Now, unless Your Honor is saying that under 105 I'm not going to get a dime – I mean, this is – I mean, obviously, you know, you've got the floodgate argument, and we've got the employees where, well, we've got to do this. And I think that it's fairly recognized that – I remember the Ameriserve case, I mean, they had a blanket, you know, deal where hundreds and hundreds of million of dollars were paid out. This seems to be a limited motion, a limited number of people. The debtor is using its business judgment and is requiring these same vendors to provide additional normal credit terms. It's not just the payment of an old debt, but there is a requirement to do more.

And I think that if Your Honor is just going to say well, I just believe in this 105 business and I'm not going to do it, that's fine. But if you believe, and I think it's fairly well accepted at this point throughout the bankruptcy system that these sorts of [134] orders are approved based upon the debtors' business judgment, it's not that big a deal when you compare it to what's going on. That's all I'm saying. It doesn't seem to be that big a deal.

THE COURT: Well, they are coming into the bankruptcy culture. There's no question about that.

MR. MISSNER: That's just my point.

THE COURT: Mr. Towbin.

MR. TOWBIN: Well, Your Honor, I think I probably have an objection to this. If in fact counsel for Fleming, you know, if they've got good reclamation rights, then they should get paid as a reclaiming seller and I'm all

for reclaiming sellers getting paid. If in fact they can get protected that way, that's a good thing.

They are not increasing their credit risk at this point in time because the stuff being delivered tomorrow or the next day they're going to get paid for. It's an administrative expense. So their claim is $76 million. And the issue is whether or not we're going to pick and choose creditors and say in the debtors' business judgment we've got to have these guys or they're going to walk away. There's no evidence before the court of that. This is just, you know, counsel and whatever telling you that this is going to happen.

[135] The problem I have is that if you grant this motion then the next things that happens is if Mr. Peterson is wrong in the prior motion and he's unsecured, they're going to say, well, he's vital, you know, so we've got to have him. So we're now going to pay the $37 million to him. Then the next thing, you know, is the next guy who's got a consignment, GE Credit or whoever, and maybe their goods are, you know necessary. Everybody's goods are necessary.

The problem I have with this is that it's only a little bit of money, it's you know, done all over and its a Delaware kind of thing, you know, is that the Bankruptcy Code doesn't allow for this. And I think we have to make a decision either we're going to follow the Bankruptcy Code or we're not. This doctrine of necessity, Your Honor that I think – and there's lots of, you know, law on that. It started with the railroads, you know, and equity receiverships in the 1890s, the public good and it's really never been applied, you know, in this jurisdiction.

As a matter of fact, Judge Schwartz got reversed by using the doctrine of necessity in one of the railroad cases, as I recall, by Judge Aspen. Your Honor, all I'm saying is I understand it's not a lot of money. I understand it's a $37 billion company. I [136] understand all of that stuff, but either we're going to follow the code or we're not going to follow the code. It's just that simple. And there is no provision in the code that says you get to pay prepetition creditors that you like, you know, and you think you want to pay them without a plan because that's what plans are for. And if you pick and chose [sic], equality of distribution is what the Bankruptcy Code is all about. And this is the antithesis of equality of distribution. And that's been in the code for a lot longer, frankly, then the doctrine of necessity in the last five or seven years that that's come out in Delaware cases.

So, frankly, Your Honor, I've got a problem with this not based upon the economics, but, frankly, Mr. Frank's client, you know, says that either you are going to pay me or I'm not going to let you advertise in my newspaper. Well, then maybe we ought to get a different advertiser, you know. And, frankly, if they've got reclamation rights, then they ought to exercise their reclamation rights. But to pick and choose individual creditors to pay and to not pay, it just seems to me there is no basis in the Bankruptcy Code to do it.

THE COURT: What does Capital Factors do?

MR. TOWBIN: Capital Factors?

[137] THE COURT: What does it supply to the debtor?

MR. TOWBIN: We basically finance vendors, other vendors that deliver goods to the debtor. That's what we do. We buy those accounts receivable. So we own $20 million of trade debt.

THE COURT: A factoring agent?

MR. TOWBIN: Exactly.

THE COURT: So you don't care if Fleming and Handleman and the egg and dairy vendors and advertising pull out?

MR. TOWBIN: Sure we care, Judge. We care. But we also care about – we care about a lot of things, Your Honor. First of all, there is no evidence before this court by those vendors on the witness stand under oath that they are going to stop doing business with the debtor unless this motion is granted tonight. And maybe the deal is going to be like a lot of times when debtors, you know, make deals with creditors on the first day. The creditors committee comes in and says, you know, maybe we can pay these guys 50 cents; maybe we can pay them 28 cents; maybe we can get better trade terms down the road; maybe we can do a lot of different things. But it seems to me, your Honor, that there is no evidence before this court that says their music [138] vendor is not going to supply them tomorrow. Frankly, if the food vendor's business is so dependent upon this debtor, why are they going to stop doing business with them?

THE COURT: All right. Let me ask you this: The U.S. Trustee has represented that they expect to have a creditors committee named next week. Would there be any harm is putting this motion over so that the creditors committee could review it?

MR. IVESTER: Yes, huge, Your Honor, and we'll put Mr. Conaway on the stand to that effect.

THE COURT: Well, lets' do that.

MR. IVESTER: Mr. Butler will put him on the stand, Your Honor.

One thing I would also like to state for the record, advertising, we have six-month lead times in advertising. If it gets pulled, we don't get the space back. And what the business – and what we've decided to do in this business is not play chicken, as Mr. Towbin would have us do, with those few people we've identified without their services our business could falter. And Mr. Towbin's client – equality of distribution, we want to have something to distribute to Mr. Towbin's client. With that I will sit down.

MR. DELNERO: May I make one comment, though, [139] Your Honor? I did speak correctly to my lead counsel about this exact issue. My understanding as I stand here is that if this is not approved, that we will not ship. That's my understanding at this moment, Your Honor. So it really is –

THE COURT: You will not ship tomorrow?

MR. DELNERO: That's my understanding, but I did not speak with the principal of the company. I spoke to my lead counsel about this issue. So it is very important.

THE COURT: All right. Mr. Conaway, would you step over to the witness stand, please, stand, raise your right hand and the clerk will swear you

(Witness sworn.)

CHARLES CONAWAY, WITNESS, SWORN

DIRECT EXAMINATION

BY MR. BUTLER:

Q Mr. Conaway, what is your position?

A I'm chief executive officer of Kmart.

Q How long have you been in that position?

A Since May of 2000.

Q Have you been in the courtroom during the presentation of the debtors' critical prepetition trade vendor motion?

A Yes, sir.

[140] Q Did you play any role in making a business judgment with respect to whether this motion would be brought before this court?

A Absolutely. I led the role.

Q Would you describe what your role was, please.

A We have over 4,000 vendors, and we looked with an incredible amount of analysis, and not just from a tactical standpoint but from a strategic standpoint, on what vendors could potentially have serious harm to the business if we were not able to continue. And we came down to a very small list, which is the one that was presented to the court.

Q Mr. Conaway, I would like to direct your attention to pages 78 and through 81 of your affidavit.

Sir, did you participate with your counsel in preparing this affidavit?

A Yes.

Q Do the statements on page 78 through 83 with respect to critical trade vendors represent your views, sir?

A Yes, they do.

Q Could you explain to me and to the court the role that Fleming has in the Kmart organization.

A Yes. Fleming is – if we break down our [141] business, we talk about frequency business, frequency business being the fastest turning businesses in our entire store, food and consumable goods. That is a frequency term in business. These are the core businesses that sustain the traffic in our stores. They're also the ones that go out of stock the quickest.

And those, to not have those – they are also a major part of our ad program, which is approximately 20 percent of our total sales. The combination of those two has a pretty devastating effect if we don't have a continuing supply, so we just get out of stock quicker.

Also we have approximately 138 SuperKs in the food business. If you do not have food available and you have any sort of an out-of-stock program with food, you absolutely destroy the franchise because customers just won't come back under any circumstances.

Q Approximately how much volume does Fleming provide to Kmart?

A Well, Fleming is one of our largest suppliers. It is, I think, over $4 billion. We went to a sole supplier

relationship with Fleming. We used to have a joint relationship between Fleming and Supervalue. Fleming is one of maybe two people who could actually service our account because of how disbursed we are.

[142] I think the court heard earlier, you know, we're within 15 miles of 85 percent of the population. We really don't have too many alternatives other than Supervalue and Fleming. And Fleming we've built a lot of critical systems and processes with, so we are able to use our distribution system efficiently and effectively.

Q Did Kmart experience a liquidity problem subsequent to January 1st of this year?

A No. The liquidity problem that we really enjoined (sic) started January 2nd with the analyst report, and then evaporation of the surety bond market sometime in late December, early January.

Q Did Fleming take any action with respect to Kmart in connection with your liquidity issues?

A Fleming has – we've been trying very hard to keep Fleming current primarily just about at any cost because of the importance that they are from a vendor standpoint. They can continually put out press releases, given the erosion in the supplier community from a confidence standpoint. And most recently this past week when we were delayed, they ended up putting out a press release that following Monday that said we were late on payment.

Q Is Fleming shipping to Kmart as we speak?

A No. We've had disrupted service. Our in-stock position has deteriorated fairly quickly. And the worst thing about this segment of the business is your high

volume stores are the ones that get affected the most and are really the ones that, quite frankly, derive the most economics in your overall business model.

Q Do you have any knowledge as to what the effects at Kmart stores has been of Fleming not shipping?

A I couldn't say from a quantitative standpoint with a definitive answer. I can tell you in my business judgment, having run the business and been in retail my whole career, our in-stock position has deteriorated about five basis points – 500 basis points. That is a dramatic reduction on the food and consumable side of the business. Our sales in that particular segment have been running down. We were running positive counts in food until January. Recently we've been about a negative 3. So I think one could correlate those two things together.

Q Have you had any conversations with Fleming regarding their relationship with you or with Kmart in the last week?

MR. TOWBIN: Objection. Hearsay, Your Honor.

[144] THE COURT: It may be premature. He can answer that question. Overruled.

THE WITNESS: Yes, I have.

BY MR. BUTLER:

Q What did you tell Fleming in those conversations?

MR. TOWBIN: Your Honor, that's hearsay. Whether he said it or Fleming said it, it's still hearsay.

THE COURT: You can cross-examine him.

You may answer. Overruled.

THE WITNESS: In our communications with Fleming, we talked about how important it was to continue to supply; that we would work every way possible to make sure that we continued with them from a liquidity standpoint to the best of our ability. When we had something solved on our capital structure we would notify them, and then, you know, react accordingly. There was an incredible amount of concern about where we were from a liquidity standpoint. And we did everything that we could to make sure that we tried to assure them when we did have liquidity and not overstate what our financial position was.

Q What type of formats does Kmart currently operate in its stores?

[145] A We operate actually a variety of sizes, from 40,000 to 190,000. The primary ones would be what's called our BigK, which is probably the traditional the Kmart that our average customer would go in. And we have about 138 stores that are SuperKs.

Q What's the principal difference between a SuperK and a BigK?

A A SuperK has all the general merchandise associated with a typical Kmart, but it has a full line grocery which would include produce, meal [sic], deli, seafood, as well as, obviously, all dry goods.

Q What is the effect, if you know, of Fleming's decision not to ship to Kmart with respect to Super Kmart stores?

A We've seen our performance on food go down pretty dramatically, and also general merchandise, which food pretty much drives the footsteps of our business. And

if food leaves those customers, our general merchandise follows because we don't have enough traffic in the stores.

Q If Fleming does not ship to Kmart, does Kmart have a alternative source of supply that it could implement in the near term?

A No, it would be devastating. Essentially, the entire SuperK business would be – that whole [146] business segment would be jeopardized.

Q What's the annual revenue of that segment?

A That entire segment, I believe, is about almost $600 million.

Q With respect to Handleman, can you explain the relationship between Handleman and Kmart.

A Yes. Handleman handles all of our music, video, and audio-video entertainment. The unique thing with Handleman, Handleman not only supplies the product to our stores but actually the service. It's a very intensive, SKU-intensive business that's hard to execute on, meaning new titles come in, new titles go out.

To keep your program fresh, the industry typically uses that type of arrangement. There is only three players in the industry that could even possibly support someone of our size. One of them does business with our largest competitor and is not willing to do business with us. And so we're down to two competitors. Of the two competitors, Handleman is one. They've done our business for a long period of time. The second one is a smaller competitor and there would be a real risk for them to be able to even handle our business. That would be questionable.

Q Do you have a view as to what would happen to Handleman if the payment that you propose to make in [147] this motion is not paid?

A I think we would seriously jeopardize our ability to have an ongoing relationship with them. And one of our chief segments, which is a critical segment for us, would potentially deteriorate.

Q What's the basis of your view?

A The basis of my view is we have seen what our business has performed when we have been out of stock, and we have seen what has happened when we put additional inventory into that category. We worked with Handleman, actually, to help put some additional inventory into those segments. During Christmas we actually gained about 300 basis points of market share, which was a much more positive trend that was happening throughout the business.

Q If Handleman was either unwilling or unable to continue to do business with Kmart, how would you replace them?

A I don't believe we have a viable alternative, particularly in the very short term, short term being three to six months. And past that I would still have a question, just given the lack of alternatives in the marketplace.

Q Do you know what the annual volume in terms of sales is of Handleman-related products?

[148] A No.

Q Would looking at your affidavit refresh your recollection? Paragraph 185, you testified to that information.

A Yes. Yes. $500 million.

Q In your affidavit you testified to egg and dairy vendors and to their importance. Can you explain for the court what is the importance to the business segment – why egg and dairy vendors are important in your business.

A Yes. I mentioned the food side of the business, how important that is to drive the whole frequency component of our business. And egg and dairy vendors are – I guess, would be furthest on that. That is actually the fastest turning items within the food, obviously, perishable in nature.

They are a fairly fragmented group. Typically if we break supply with them and we don't have relationships with them, they just cease to serve you. They are a very dispersed group. And if you don't have that kind of core product, you are totally incomplete to your customers.

THE COURT: Do you have a list of these critical vendors?

THE WITNESS: We have them aggregated. It [149] was a little over, Your honor, $8 million. In fact, I think it was about $8 and a half million and – 6.8, excuse me. And we have a detailed list. I'm not sure we have that with us. There is a number of suppliers.

THE COURT: So you can provide a list?

THE WITNESS: Yes, we can, Your Honor.

BY MR. BUTLER:

Q You also testified in your affidavit, Mr. Conaway, to advertising issues. Can you explain to the court why advertising is considered a critical vendor when you've excluded so many other vendors from this program?

A Yeah. We are a high-low retailer. High-low retailer meaning that our main way of going to market is with an advertising program. We have a ROTO (phonetic) or circular that is out in the market every Sunday, 52 weeks a year, and then we also have additional advertising throughout the year in addition to that, that may break midweek or around a holiday, depending around critical sales periods.

Our business, as I mentioned, about 20 percent of our business is really driven by this ROTO. It is a critical element. Not just those sales, but what it does to the overall business. So we use the ad not just to drive promotional merchandise, but also to [150] drive the footsteps into the stores so we can sell other things that are not in it.

Our ROTO program is all based primarily with major newspapers, and local newspapers in smaller markets. We have no alternative in most of the major markets. If we were not to get placement in an ad program, it would be devastating to the program, to our overall business model.

THE COURT: Could you explain what this entire circular advertising program, including circular layout and development, commodity paper, procurement, circular printing, newspaper placement and distribution, is.

THE WITNESS: Yeah. That whole program is the production of our circulars, which for the most part, your Honor, gets inserted into the newspaper every Saturday or Sunday, depending on the market. Our ad layout, essentially we are working about 12 weeks out, meaning items that are going to be dropping in 12 weeks from now, the actual circular is already done. So there is not a long lead time to do that.

The program is worked out every week, coordinated with our supplier base to make sure that we have the appropriate in-stock position. If we don't, rain check is a critical component to not disappoint our [151] customer. And that whole production of that ad is done through the various components that you asked.

THE COURT: So you have planned now for circulars to be inserted in newspapers going out 12 weeks?

THE WITNESS: Yes. This week would be for 12 weeks out, would be final. So as of next week we couldn't change anything in that circular, the actual physical circular.

BY MR. BUTLER:

Q Finally, Mr. Conaway, two other lines of questioning. First, during the break did you discuss with me another critical vendor that you wanted to add to the program?

A Yeah. Unfortunately it was an oversight. Penske, actually our supplier, runs the automotive side of our business. We got into the arrangement with Penske because that business is a fairly complicated business. Hiring needs there are fairly complicated. If you look at the mechanics that are hired in there, that's one of the

harder jobs to actually place in the marketplace. If you look throughout our stores, probably that and pharmacist and store managers.

Penske brought a real core competency to be able to run that. It is a business that was losing a [152] substantial amount of money under our prior, I guess, ownership and running of that business. The Penske organization has really done an outstanding job of bringing that back up to break-even. It would be critical to make sure that that relationship continues.

I can tell the court that if they exited that business and decided not to go forward because it's not a very profitable business, we would have to totally exit that segment, and we would displace, obviously, a lot of associates. But, more importantly, our overall offering to our customers would be incomplete in that our main competitors have this and we just wouldn't be able to provide it.

Q Have you had any conversations with representatives of the Penske organization about this business recently?

MR. TOWBIN: Objection, Your Honor. Hearsay. It's an out-of-court statement.

THE COURT: Overruled. You may answer that question. Yes or no?

THE WITNESS: Yes.

BY MR. BUTLER

Q You testified that you don't believe there would be any way to replace this organization. If the Penske organization were to withdraw their support, is [153] there

no alternative than to disband this segment of the business?

A Yes. We have looked at alternatives from a strategic standpoint, and there are no alternatives that we have been able to find.

Q Do you have any estimate of the sales revenue of volume of the Penske business?

A The Penske business, I don't off the top of my head.

Q All right. The last question I want to ask you, Mr. Conaway is you heard, I think during this hearing, the court's concern about how you differentiate between these vendors that you have deemed as critical and your other 3,995 vendors. And can you explain to the court in your own words how you reached the business judgment that these vendors ought to be brought forward on this program as opposed to the other nearly 4,000 vendors.

A Yes. There is really two dimensions. One was strategically of what does it mean for the business, meaning what is its role; within the category I talked about, Fleming, and how important that is from a commodity and frequency building standpoint. And the second one, quite frankly, which was the overriding one, was do we have any alternatives. In virtually all of [154] these cases from a practical matter when we walked through them, we don't have any viable alternatives. And given that we would have to exit that business, it would severely deteriorate the business in any one of those segments.

MR. BUTLER: Pass the witness, Your Honor.

THE COURT: Cross-examination.

MR. TOWBIN: Your Honor, can I do it from here?

THE COURT: I would prefer it if you would stand at the lectern. It makes it easier for the court reporter.

CROSS-EXAMINATION

BY MR. TOWBIN:

Q Does Kmart have a written contract with Fleming?

A Yes, they do.

Q What's the term of the contract?

A I do not know in detail the terms of the contract.

Q Is it a supply contract?

A Yes, to supply all of our food and consumable items, what we call our pantry division in our BigKs, as well as all of the food or most of the food, I should say, in our SuperKs, the grocery side of the business.

[155] Q And has Fleming sent you any notices that they were going to dishonor their obligations under the contract?

A The best that I'm aware, no, I have not received any written notices.

Q Now, you say that Fleming is not shipping now. You mean, from what I read in the newspaper, you missed a payment to them and they decided not to ship. Is that

what we're talking about, the prepetition period? Well, the case was filed today so it's got to be prepetition?

A Well, I mean, they weren't shipping prior to this. I can't give you an exact date. And they are not shipping today.

Q But you have the money in the bank and you are willing to pay COD and you're willing to even pay in advance, I assume, to get Fleming to ship to you on a go forward basis?

A No, I'm not willing to COD anybody. Paying COD would substantially jeopardize our business model and the economics that we're working so hard to make sure that we maximize.

Q But if you were required to do that to get their support you would pay that?

A No, we are not prepared as a management team [156] to pay COD.

Q You'd rather lose them as a supplier than pay COD?

A No, I'd rather honor our existing relationship continue forward and have a good viable business model.

Q If you had to choose between paying them cash or losing them as a vendor, which would you do?

A I'm not prepared to answer that because I think that would be reckless without a lot of thought.

Q By the way, do you have a written agreement with Handleman?

A Yes, we do.

Q And have they sent you any notice saying they are not going to honor their written agreement postpetition?

A I'm not aware of any written agreement, and I know of no such written agreement, or notice excuse me.

Q So there is a written agreement but there has been no notice that they are going to dishonor their obligations; is that right?

A Not that I'm aware of.

Q Have you received reclamation notices from Handleman that you're aware of?

A I'm not aware.

[157] Q Your egg and dairy vendors, you want to pay them how much money?

A I believe it's about 6 or $7 million approximately.

Q I think you said they're a pretty diverse group of folks?

A Uh-huh.

Q So there are other egg and dairy vendors around other than the ones you use now?

A No. Actually the only vendors that are meaningful in retail are the ones that can supply your actual stores. So while there's – again, we're all over the country. So while there is a lot of egg and dairy vendors, there is typically only one in the market in which you serve. So in that case there is a monopoly for that market.

Q So there is no alternative at all to the egg and dairy vendors?

A No, I didn't say that. But the issue of a dispersed vendor base means that it is dispersed across the country because we are everywhere, concentrated within the local market in which they serve.

Q If you couldn't buy from the current egg and dairy vendor that took care of your Montana market, would there be somebody else you can go to? Or are you [158] just out of business up there?

A When I spoke to my directs who runs the SuperK division, the information I got from them is there would be a number of stores that could not get service. I couldn't give you an exact number on that.

Q And do you have any written agreements with these egg and dairy vendors?

A I'm not aware whether its written or not written or just normal course.

Q Have you gotten any notices that unless you pay this prepetition debt, they're not going to ship postpetition?

A I'm not aware of any such notices.

Q Now, let me ask you about the advertising. Do I understand that for the next four, five or six weeks you're going to have advertising out on the street? It's already been placed and its going to be out there?

A No. Just because we have printed a circular, if a newspaper cuts us off it's actually the worst of all worlds. We've spent the expense to do the circular, we have the ad product, yet it doesn't get placed in the newspaper. Just

because we have it printed, the key thing is that it gets in the newspaper.

Q So it's a matter of distribution?

[159] A Yes. Well, it's a matter of actually producing the circular, having the merchandise and getting it in place.

Q So you've already paid for everything except the distribution?

A When you say we've paid for everything, given the filing to day I'm not sure exactly what we've paid for and what we haven't paid for throughout that process.

Q And, again, do you have a contract with these advertisers? Do you have written agreements with them?

A I believe we have written agreements with – I know we have with some of them. I couldn't tell you. We deal with a variety of newspapers.

Q All right.

A So I'm not sure.

Q And have you gotten any notices from any of those folks that they are going to stop doing business with you if you don't pay them tomorrow this prepetition debt? Did you get any such notices?

A No, we did not get any such notices, but it is normal course that newspapers typically take pretty swift action, in my experience, in retail. And that's been pretty consistent with other –

Q Meaning in bankruptcies they don't service [160] you if you don't pay the prepetition debt?

A No. Well, they have a major disruption in service, and it takes a long period of time. It's not just the circular. It's also run the press. And newspapers can do some – can put you in a very favorable position in the paper or a very unfavorable position, and that has a significant impact on sales.

Q Does your contract specify where you're going to be placed?

A Typically not.

Q So they can put you on the back page instead of the front page?

A Depending on the arrangement yeah. So how strong your relationship is with them is very important.

Q Has anybody suggested that they are going to put you in a bad location in the newspaper if you don't pay them tomorrow?

A Yes. Our advertising – again, I've had an opportunity to talk to a lot of advertising newspapers lately and –

Q So you haven't gotten any such notice –

MR. BUTLER: Objection, Your Honor. Could counsel let him answer the question.

MR. TOWBIN: I thought he was done.

THE COURT: Sustained.

[161] BY MR. TOWBIN:

Q Have you gotten a notice that they are going to change where they're going put to [sic] your ads in the newspaper?

A I have been advised by people who work directly for me who are directly accountable for the ad program that that will occur.

Q That's their speculation –

MR. BUTLER: Objection.

MR. TOWBIN: I'm sorry.

THE COURT: Sustained.

THE WITNESS: I can't comment –

THE COURT: The objection is sustained.

THE WITNESS: Okay. Sorry.

BY MR. TOWBIN:

Q Is the advertising market right now pretty soft?

A The advertising market, I couldn't comment on whether it is soft or not right now. It was soft in the fall, I know, when people got a lot of rate negotiations. I wouldn't comment right now. I'm not sure.

Q So you don't know the market right now?

A No.

MR. TOWBIN: Nothing further, Judge.

[162] THE COURT: Redirect?

MR. BUTLER: No redirect, your Honor.

THE COURT: All right. You may step down, sir.

THE WITNESS: Thank you.

(Witness excused.)

THE COURT: All right. Motions to pay certain critical trade creditors always present difficult questions for courts. We're seeing more and more of them, and our problem is that we have to stretch to find some authority to do them. However, I, after hearing this testimony and reading the affidavit, am convinced that Fleming, Handleman and the egg and dairy vendors – and I would like a list of the specific vendors that you would like included in this motion – as well as the advertising concerns, are necessary to keep this business going as a going concern.

I am not going to rule on the request filed by Penske because I don't know what kind of a sales volume, I don't have really very much, you know, coming into evidence that is presented –

MR. MISSNER: May I recall the witness, Your Honor?

THE COURT: I would like to see a motion.

MR. MISSNER: It was only $5 million, and the [163] reason that I didn't cross-examine him, I didn't want to take up the time because of the lateness of the hour. But the fact of the matter is, in our case they take our money. In other words, this isn't a critical vendor issue. We are part of the Kmart system. And when the money comes in, it doesn't go to us. It goes to them. So they get our money, and then at the end of the week they give us back our money. So it's not even – it's more – it's really not – it's a trust issue. In other words, it's not even a critical vendor in my view. They have our money.

THE COURT: All right.

MR. MISSNER: And its a minimal amount, and basically, if we don't get that money, okay, we can't pay our employees come this Friday.

THE COURT: All right. Mr. Missner, would you work with the debtor and either the debtor file a motion or file the appropriate motion. I'm trying to deal with just the matters that I have before the court today. I have so many creditors in this courtroom, and I still have several motions to go through.

I have a couple of other comments on the order that I ask that you – now, it appears on page four of the order at the bottom of the page in paragraph six you have left out any reference to postpetition [164] claims. It says, "outstanding without." Do you see where I am?

MR. IVESTER: Yes, Your Honor.

THE COURT: And on the next page it appears that you omitted a reference to return of amounts pre and postpetition claims, which if you refer back to page 14 of your application you request.

MR. IVESTER: Yes, Your Honor.

THE COURT: And then if you will take out the other language that we're taking out of all the orders, I will show this as draft order to follow.

Motion for authorization of payment of certain prepetition shipping and delivery charges.

MR. IVESTER: Your Honor, in the interest of time, again, these are shippers that have goods on their trucks or in their boats heading toward us. We want to make sure that there is no question that they are going to be paid. I, frankly, was two blocks in the car – two blocks away when I got a call from Mr. Donald Gaffney, representing our largest shipper saying when I got out of the hearing if this order was entered he would tell the trucks to keep on coming.

THE COURT: Do you have a list of these?

MR. IVESTER: Your Honor, I'm sure we do. We don't have one attached to the motion, but we would be [165] happy to come up with a list.

I think I'm being told we don't have a list. We've tried to estimate what the shipper amounts would be.

We also have the armored car issue. Every day we have armored cars going to our various locations to collect the deposits and then deposit those in our various banks and depository institutions at the local level, and those are also covered by this motion.

THE COURT: How much is owed to the shippers and to the armored car carriers?

MR. IVESTER: Your Honor, I'm not sure if we are able to quantify that with precision right now. I think we've got some averages in the motion on an annual basis that we pay roughly $1.2 billion a year. It is not my impression that a straight average of that is applicable,

especially since this is not a typical year when as much is delivered as it would be around a holiday season.

But, again, what we want to do is ensure that whatever those claims are in the ordinary course, that those shippers are paid and the customs agents are paid and the various people that will allow those goods to flow into the debtors' possession. And what we can't have is an interruption while those parties try to [166] determine whether or not it is a prepetition claim or whether or not it's a postpetition claim, and whether or not they need some sort of security while the trucks are circling.

As Mr. Gaffney said, this motion, entry of an order would give him the certainty he wanted even though he hadn't received payment yet, to tell the trucks to keep on coming to our locales. And I certainly can make that representation because I received that call on the way in.

THE COURT: What's the U.S. Trustee's view on the breadth and the depth of this order?

MS. GLEASON: Again, Your Honor, I think this is the business judgment of the debtor. I had asked that they put it off, and they indicated to me that it could not be. It's their business judgment and we have no grounds to challenge it.

THE COURT: Okay. And you tell me that you can't generate a list of these carriers?

MR. IVESTER: I'm sure we can get you a list of who would be covered. I'm not sure we can ascribe an amount with precision as of this day.

THE COURT: All right.

MR. IVESTER: I think we have a lot of shippers out there, and I think with some effort we [167] could find out who those are. Of course, if that took a long time, it may defeat the benefit of being able to pay them.

THE COURT: It may create further problems. All right. I will enter an order again striking the language earlier recited making the finding that the motion is granted. Draft order to follow.

Is the next one reclamation claims?

MR. IVESTER: Yes, Your Honor. Maybe if I could just address that one. The vendor return program and the PACA and PASA which are, in the interest of time, matters 25 and matter 28 and matter 29, these are procedures that have been used in other cases that we seek to implement. This is on an interim basis only. And unless Your Honor would like to hear more about that at this time, in the interest of time and the lateness of the hour we move to enter those on an interim basis.

THE COURT: The U.S. Trustee is in agreement?

MS. GLEASON: Yes, Your Honor. We view this as a means to set up a procedure for making reclamation claims and dealing with that. Anyone would have the right to come in and challenge.

THE COURT: All right. You want these matters then continued after an interim order is entered until February 14th?

[168] MR. IVESTER: The 13th, Your Honor.

THE COURT: Excuse me, February 13th.

MR. IVESTER: Yes, Your Honor.

THE COURT: Can we do them at 11:00 o'clock?

MR. IVESTER: Yes, Your Honor.

THE COURT: Draft order to follow. 26, motion to pay contractors.

MR. BUTLER: Your Honor, these are the people that are doing a variety of things, including build-out in our stores, and providing goods and services in the building. Some of these very well could have mechanic's liens and material man's liens, which could be levied against the property or assessed against the property absent payment.

What we don't want to do is to have a disruption in the build out of a store. And we stated so in the affidavit. We have set forth that the prepetition amounts for repair and remodeling and construction activities may be as much as $43.7 million. However, we do believe based on our past practice that much of that will be potentially, if those parties are not paid, subject to valid M&M lien claims. And, again, we don't want to fight that fight and suffer the damages incurred only to find out that they were right.

THE COURT: All right. So you're asserting [169] that if – and they have the right to file mechanic's liens, that this would be disruptive to the debtors' reorganization?

MR. IVESTER: If they put their efforts to file an M&M lien on a property, on a half built out store, or a

store in the middle of remodeling, that would be devastating to the – even that build out or that capital improvement project or that capital expenditure.

THE COURT: Is there any lien rights out there that the creditors committee should have a right to review presently?

MR. IVESTER: You know, I don't know what type of lien rights have been filed to date, Your Honor. I know that the company when there are stores wants to complete the build-out of the store and doesn't want to suffer that interruption while they're trying to find out whether it's valid or not. They want to make sure that we go ahead and get that store and get it in operation or get the remodeling and get that in operation, or get the capital repair and get whatever that may be back and running. And, in fact, they have tried to limit that, and have an estimate that that would be no more than 43.7 million –

THE COURT: Have any of these contractors [170] threatened to walk off the job?

MR. IVESTER: I think, candidly, it's my guess right now, Your Honor, that it's too soon in the cycle and only just now will we start to receive those. In between this morning and this afternoon I saw some sort of a notice to this effect, and but in the time since we have filed we have not – candidly, have not had time to sit back and assess whether or not that would in fact occur.

THE COURT: Ms. Gleason, do you see any reason why the creditors committee may have an interest in reviewing any liens if there are any?

MS. GLEASON: Maybe to the extent that a similar type of provision that was put into the –

THE COURT: Consignment vendors.

MS. GLEASON: That would make sense.

THE COURT: All right. Could you insert some similar language in this order that would preserve the rights of the creditors committee if there was not properly perfected liens, that they may be able to attack it, and run that language by the U.S. Trustee.

MR. IVESTER: Yes, Your Honor.

THE COURT: Draft order to follow.

All right. Now the goods that are coming from foreign countries.

[171] MR. IVESTER: Foreign vendors, Your Honor. These are goods that we have identified that are in the hands of or are presently being shipped by foreign vendors who are owed, I think the number was $43,200,000. These are people that are arguably outside the jurisdiction of this court. We do import a fair amount of our products from overseas. And we do not want that to be disrupted.

These are people, that they can, in fact, fold their arms and say, you know, I'm not going to ship until you pay me. May[illegible] it's not fair that they are outside the jurisdiction or inside the jurisdiction, but we, nonetheless, still need to do business with them and obtain the goods as set forth in Mr. Conaway's affidavit, for the reasons stated, for the goods that we are receiving from these foreign vendors.

MR. TOWBIN: Your Honor –

THE COURT: The foreign vendors would have the right to recall these ships, and the ships could ultimately turn around?

MR. IVESTER: That's my understanding, Your Honor. That's the ones we have targeted.

MR. TOWBIN: Your Honor, just to be consistent with this, I understand counsel's problem. I have the same problem in my own cases. We would object [172] to the payment of any prepetition claim. Frankly, these things are mostly done on letters of credit anyway, so I'm not sure what the magnitude of this is. I don't understand why. If it's overseas goods, it [sic] always on a letter of credit.

MR. IVESTER: That's certainly a generalization. That doesn't apply to everyone that imports from overseas. We've had a pretty good track record paying in the past. And if it was covered by a letter of credit, we're not putting them on the list, unless, of course, it would be some benefit to us as far as a credit facility is concerned.

THE COURT: Do you have a list of these foreign vendors?

(Inaudible)

THE CLERK: I can't hear. I don't know who is speaking. Can you identify yourself.

MR. YOUNG: Yes, Your Honor. Sean Young from Pricewaterhouse Coopers. We do not have a complete list of the foreign vendors. I can give you an aggregate number, though. About 150 vendors.

And I just want to make one other point. That $43.7 million is on an open account. It's not covered by a letter of credit.

THE COURT: Okay.

[173] MR. IVESTER: We would like these goods. I think it would benefit everyone, including Mr. Towbin's client if we get this.

THE COURT: I'll sign an order. Draft order to follow.

MR. IVESTER: Thank you, Your Honor.

MR. BUTLER: Your Honor, as we come to the conclusion of this first-day hearing we have two matters that are left. One I hope to dispose of in short order, because the facts are that Ms. Gleason and I and Mr. Ivester and others did spend a fair amount of time trying to figure out what to do on an interim basis and what to do on a final basis. And we actually have a proposal with respect to matter number 30 that I think Ms. Gleason subscribes to that ought to hopefully make shorter shift of this.

We have 350 leases here, approximately, that we need to reject. We filed this motion on the first day and sought relief on the first day because we want to avoid the administrative expenses associated with these leases. We have a proposed order, Your Honor, that would do two things. First, with respect to the Group A leases, those are general leases that are dark stores. They're closed. They're in our closed store inventory. What we would propose to do is have an [174] arrangement that would – where Your Honor would enter an order today rejecting the leases, subject to negative notice to the landlords. So that if a

landlord wanted to come in here the landlord could come in and file an objection. We would have to make a case at the next omnibus hearing with respect to it. You would determine whether we could reject or not. We don't think the standard for rejection is very high under the case law, but we would go through that so due process is maintained.

But if Your Honor sustains our motion, the effective date of rejection would be the petition date. So the estate would not have any issues with administrative claims here. As I said, these are closed stores. We are out of them. We're vacated and we're quite pleased to have the landlords take over the space. That would take care of the Group A stores. And we would do it on a negative notice basis so that we would provide that additional noticing procedure for them.

With respect to the Group B stores, which are the subleasing stores, that we've actually added procedures for rejecting those leases which essentially is a ten-day noticing arrangement that says that without coming back to court as to the scheduled ones – and Your Honor, this time we do have schedules that are [175] specific – that we would have the ability to reject those leases on ten-days' notice without coming back to court, providing we gave that ten-day notice to the landlord, otherwise complying with the term of the orders, that notice would become effective on the 10th day.

And we have agreed with Ms. Gleason that notice would be simultaneously delivered to the creditors committee so that they would be aware of the issues and have that ten-day period either if they disagree with our judgment to talk to us about it or take other action.

We think that is an appropriate disposition of this one. Just to underscore to the court, that we thought we could actually come to an arrangement today where the court could find a way to grant the relief but also take care of some of the notice issues Your Honor has discussed.

THE COURT: All right. Can you tell me the status of the schedule B leases?

MR. BUTLER: For the most part my understanding is that they are subleases; that is to say, we're no longer operating in the stores. None of the leases on this motion are stores that we're currently operating a SuperK or a BigK at. This is part [176] of our closed-store inventory we've actually been able to sublease to a third party. Unfortunately, the sublease income doesn't correspond to the master leasing payments we have to make, so we are under water. These leases have all been reviewed by our outside real estate financial advisors, Rockwood Gemini, and they have expressed a point of view here to underscore the debtors' business judgment for rejection.

THE COURT: All right.

MS. KEYWELL: Excuse me, Your Honor. Your Honor, my name is Synde Keywell. I signed the appearance list on behalf of possibly 150 of the debtors' over 2,000 locations to appear tonight as local counsel. And on behalf of those clients we do have problems with Mr. Butler's proposed order.

Certainly we have no problem with the negative notice on the debtors' exercise of business judgment to reject the leases on list number A. Where we do have a problem is Mr. Butler explained that he didn't want any problem with administrative rent, and that if there were

no objections that the court would treat today as the effective date and there would be no administrative rent.

Unfortunately, the debtor may not have given possession to the landlord of the over 200 leases on

* * *

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In re BETHLEHEM STEEL CORPORATION, et al., Debtors. UNITED STATES TRUSTEE, Appellant, -against- BETHLEHEM STEEL CORPORATION and UNITED STEEL WORKERS OF AMERICA, Appellee.

02 Civ. 2854 (MBM)

UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

2003 U.S. Dist. LEXIS 12909

July 23, 2003, Decided

July 28, 2003, Filed

COUNSEL:

TRACEY HOPE DAVIS, ESQ., Department of Justice, Office of the United States Trustee, New York, New York, for Appellant.

JOSEPH A. GUZINSKI, ESQ., General Counsel PAUL W. BRIDENHAGEN, ESQ., Trial Attorney, Executive Office for the United States Trustee, Washington, D.C., for Appellant.

HARVEY R. MILLER, ESQ., MICHELE J. MEISES, ESQ., JOHN C. NG., ESQ., Weil Gotshal & Manges, New York, New York, for Bethlehem Steel Corp., Appellee.

BABETTE A. CECCOTTI, ESQ., ROBIN H. GISE, ESQ., Cohen Weiss & Simon, New York, New York, for United Steel Workers of America, Appellee.

JUDGES:

Michael B. Mukasey, U.S. District Judge.

OPINION BY:

Michael B. Mukasey

OPINION:

OPINION AND ORDER

MICHAEL B. MUKASEY, U.S.D.J.

The United States Trustee ("U.S. Trustee") appeals from an order of the Bankruptcy Court dated January 7, 2002, authorizing Bethlehem Steel Corporation and certain of its direct and indirect subsidiaries (collectively "Bethlehem"), as debtors and debtors in possession, to reimburse the United Steel Workers of America ("USWA") for certain professional fees and expenses. For the reasons stated below, the order of the Bankruptcy Court, to the extent that it allows reimbursement of up to $1.4 million in fees and expenses, is affirmed.

I.

On October 15, 2001, Bethlehem commenced a case under Chapter 11 of the Bankruptcy Code. After that date, Bethlehem continued to operate its business as a debtor in possession under § 1107(a) and § 1108 of the Bankruptcy Code.

On November 29, 2001, Bethlehem moved pursuant to § 105(a) and § 363(b) of the Bankruptcy Code for authority to reimburse the USWA for certain costs and expenses. According to Bethlehem's motion, it employed approximately 13,200 persons, approximately 80 percent of whom

were covered by one master collective bargaining agreement and several plant-specific agreements and settlement agreements with the USWA. (R., Ex. 1, at 2)[1]

Bethlehem asked for authorization to make payments according to the terms of two letters ("USWA Letter" and "Keilin Letter"), attached to Bethlehem's motion. In the USWA Letter, dated November 5, 2001, Bethlehem agreed to reimburse the USWA for work performed by lawyers, accountants, actuaries, and others on an attached list of professionals.[2] (R., Ex. 1, USWA Letter at 1) The professionals would be used by the USWA to "undertake the due diligence and analysis that will be required in order for [the USWA] to participate in discussions regarding the restructuring of the Company, including, but not limited to, negotiations regarding possible modifications to the existing labor and benefits agreements with the USWA." (*Id.*)

The reimbursement would be based on "each professional's usual and customary rates" and "subject to an overall cap of $1.5 million for the period commencing October 15, 2001, and ending April 15, 2002, or upon payment of $1.5 million, whichever occurs later." (*Id.*) In addition, the USWA Letter stated:

> Each professional and the Union shall submit to the Company and any committee of creditors

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[1] All references to U.S. Trustee's Designation of the Contents of the Record on Appeal will be cited as "R."

[2] The letter agreement was entered into by Robert S. Miller, Jr., Chairman and CEO of Bethlehem, and Leo W. Gerard, USWA's President. (R., Ex. 1, USWA Letter)

> appointed by the Office of the United States Trustee, consistent with the guidelines for professional compensation adopted by the United States Bankruptcy Court for the Southern District of New York, a written statement describing the professional services performed, the persons who performed the services, the time expended by each such person together with that person's billing rate, and a detailed explanation for all disbursement for which reimbursement is requested. If no objection is interposed to the submitted statement, the Company shall pay the reimbursement requested. If any objection is interposed to any portion of a submitted statement, pending resolution of that objection, the Company shall not pay the disputed item. The Company and interested parties shall make every effort to amicably resolve any disputes as soon as practicable. If the dispute is not resolved within five business days after any objection is interposed, any party may request that the Bankruptcy Court resolve the dispute.

(*Id.*)

The USWA Letter said also that Bethlehem agreed to pay a "success fee" of $5 million to the USWA's investment banker, Keilin & Co., payable when a plan was confirmed. The Keilin Letter described this compensation agreement in greater detail, and included various indemnification provisions.[3] (R., Ex. 1, Keilin Letter)

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[3] The Keilin Letter, attached to Bethlehem's motion, is unsigned and undated.

The U.S. Trustee opposed Bethlehem's motion before the Bankruptcy Court, arguing, as she does here, that § 363(b) cannot be used to authorize the reimbursements. (R., Ex. 2) The Official Committee of Unsecured Creditors ("the Committee"), took the position[4] that it was "necessary and appropriate for the USWA to receive competent and comprehensive advice and counsel," (R., Ex. 3, at 3), and in "light of the critical role that the USWA must play in a successful reorganization of the Debtors' estates," the Committee did not object to "the Debtors' reimbursement of the USWA for $1.5 million in professional fees and disbursements over the first six months of the case," (*id.* at 4). However, the Committee argued that Keilin should be allowed a success fee only "to the extent that Keilin helps achieve a favorable result in these cases that is supported by the USWA," and "any success fee must be reasonable." (*Id.*) The Committee recommended that the success fee be subject to review by the Bankruptcy Court under the same standards set forth in § 330 of the Bankruptcy Code. (*Id.*)

Judge Lifland held a hearing on December 19, 2001. (R., Ex. 5) At the hearing, he heard from the U.S. Trustee, the Committee, Bethlehem, and the USWA. In addition, the pre-petition lender group expressed support for Bethlehem's motion. (R., Ex. 5, at 47)

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[4] The Committee's response said that the USWA was a member of the Committee, but did not participate in the Committee's consideration of Bethlehem's motion, due to its "conflicting interests." (R., Ex. 3, at 2 n.1)

At the hearing, the Bankruptcy Court said:

> I do consider that this is a unique case and I understand the tensions that exist. I understand the needs of the case and the very important public interest that is represented by the unions in this case, because ultimately, in some form or other, the taxpayer is going to have to pick up some of the obligations that are represented by shortfalls in connection with this case. . . .
>
> But in any event, there is this public interest, and I think there is this need to take a practical approach and approve this kind of retention, bearing in mind again that under 503(b), should there be such an application, there is a potential of those applications being offset by this advance payment.

(R., Ex. 5, at 59-60) The Court said later in the hearing: "Under 363 today, there is sufficient justification for me to consider this unique application, combined with Section 105. Given the public interest, that goes beyond merely the union, it goes to its members, the retirees, a good part of the tax base of many important communities in the United States." (*Id.* at 67)

On January 7, 2002, the Bankruptcy Court issued an Order (the "Order"), authorizing Bethlehem to reimburse the USWA for "its reasonable professional costs and expenses in accordance with the terms" of the USWA and Keilin Letters. (R., Ex. 4, at 2) However, the Order made several modifications to the Letters. The Order said that the reimbursement could "not exceed $1.4 million exclusive of any Success Fee" (*id.* at 2), and it removed the USWA's in-house professionals from the list of those whom Bethlehem was authorized to reimburse, (*id.*). The Order

directed that the various reimbursement statements be filed with the attorneys for the agent for pre-chapter 11 lenders, in addition to the entities set forth in the USWA Letter. (*Id.* at 3) The Bankruptcy Court adopted the terms of the Letters regarding the success fee, but incorporated changes suggested by the Committee. In particular, the Order said that Bethlehem was authorized to pay Keilin a fee of up to $5 million, but only upon 1) confirmation of a plan or the sale of all or substantially all of Bethlehem's assets, which is "supported by the USWA" and 2) "review and determination of the application [for the fee] by the Court pursuant to Section 330 of the Bankruptcy Code, after the confirmation or sale." (*Id.* at 3) Finally, the Order subjected the indemnification provisions of the Keilin letter to various conditions, including that any requests under the provisions by Keilin would be reviewed by the Court. The Order stated: "The Court shall retain exclusive jurisdiction to construe and enforce the terms of the Keilin Letter, Exhibit 'A2', any Application made by Keilin and this order." (*Id.* at 5)

II.

Title 28, Section 158(a), of the United States Code governs appeals to district courts from bankruptcy courts. Section 158(a)(1) gives district courts jurisdiction to hear appeals "from final judgments, orders and decrees" of bankruptcy courts. 28 U.S.C. § 158(a)(1). Although neither party has raised the issue, this court is obligated as a threshold matter to determine whether it has jurisdiction. *See Bernard v. Masterwear Corp.* (*In re Masterwear Corp.*), 1998 U.S. Dist. LEXIS 19563, No. 98 Civ. 0688, 1998 WL 879694, at *2 (S.D.N.Y. Dec. 16, 1998); *see* also *In re*

Integrated Resources, Inc., 3 F.3d 49, 52 (2d Cir. 1993) (raising the question of appellate jurisdiction sua sponte).

"For purposes of appeal, the concept of 'finality' is more flexible in the bankruptcy context than in ordinary civil litigation." *In re Palm Coast, Matanza Shores Ltd. P'ship*, 101 F.3d 253, 256 (2d Cir. 1996). The Second Circuit has explained:

> Properly understood, the relaxed approach to finality in bankruptcy cases is appropriate "because bankruptcy proceedings often continue for long periods of time, and discrete claims are often resolved at various times over the course of the proceedings." *In re Chateaugay Corp.*, 880 F.2d 1509, 1511 (2d Cir. 1989). This "pragmatic approach to finality" does "not overcome the general aversion to piecemeal appeals," however. *In re Chateaugay Corp.*, 922 F.2d 86, 90 (2d Cir. 1990). We merely seek to avoid a situation where an otherwise "final" order – e.g., an order resolving all of the claims asserted within a discrete adversary proceeding – is rendered "nonfinal" simply because it arises in the context of a bankruptcy proceeding.

In re AroChem Corp., 176 F.3d 610, 619 (2d Cir. 1999); *see* also *In re Kurtzman*, 194 F.3d 54, 57 (2d Cir. 1999) (per curiam) ("We have previously explained that 'orders in bankruptcy cases may be immediately appealed if they finally dispose of discrete disputes within the larger case.'" (quoting *In re AroChem Corp.*, 176 F.3d at 620)); *In re Fugazy Express, Inc.*, 982 F.2d 769, 776 (2d Cir. 1992) ("For a bankruptcy court order to be final . . . the order need not resolve all of the issues raised by the bankruptcy; but it must completely resolve all of the issues pertaining

to a discrete claim, including issues as to the proper relief.").

The U.S. Trustee apparently appeals from the entire Order, although her papers focus on the portion of the Order authorizing payment of $1.4 million.[5] In any event, for the reasons stated below, the portion of the Order dealing with Keilin's success fee is not final and will not be reviewed here.

The Order provides that Bethlehem is authorized to pay Keilin a success fee only after the confirmation of a plan or sale of all or substantially all of Bethlehem's assets, and "review and determination of the application [for the fee] by the Court pursuant to Section 330 of the Bankruptcy Code."[6] (R., Ex. 4, at 3) Thus, the Order clearly provides that further review by the Bankruptcy Court is necessary before any success fee payment is authorized.

A finding that the portion of the Order dealing with the success fee is interlocutory is consistent with the holding in *In re Integrated Resources, Inc.*, 3 F.3d 49 (2d

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[5] The U.S. Trustee mentions the success fee twice in her papers. Both references state that, with the exception of the success fee, the Order authorized the payment of professionals without further order by the Bankruptcy Court. (U.S. Trustee's Br. at 4 n.4, 11 n.5) The U.S. Trustee acknowledges that the Bankruptcy Court "reserved the right to review the success fee of up to $5 million for Keilin & Co." (*Id.* at 4 n. 4)

[6] Section 330 allows the bankruptcy court to award "reasonable compensation" to professional persons employed under § 327 or § 1103. *See* 11 U.S.C. § 330. Neither party asserts that Keilin was retained under § 327 or § 1103. However, it appears that the Bankruptcy Court intended to apply the criteria for "reasonable compensation" contained in § 330 in reviewing the success fee.

Cir. 1993). In that case, the Second Circuit held that the Bankruptcy Court's order, which approved a break-up fee arrangement between the debtor and a potential funder of a reorganization plan, was interlocutory. *Id.* at 52. Bankers Trust, the potential funder, and Integrated, the debtor, entered into a "Letter of Intent," which said that Bankers Trust would receive reimbursement for expenses incurred in connection with its business review of Integrated, and required Integrated to pay Bankers Trust a break-up fee in an amount that depended on certain future events. *Id.* at 51. The Bankruptcy Court approved the agreement after the parties lowered the amount to be paid by Integrated. *Id.* at 52. While the order was being appealed, negotiations between Bankers Trust and Integrated ended, and the parties disagreed about how much Integrated owed Bankers Trust. *Id.* The Second Circuit said:

> It is certainly conceivable that an order approving an agreement for a breakup fee could satisfy this standard [of finality]. The parties made clear at oral argument, however, that even assuming the validity of the compensation provisions of the Letter of Intent, Integrated Resources and Bankers Trust remain literally millions of dollars apart as to the amount owing to Bankers Trust thereunder.

Id. at 53. The Court said further: "The bankruptcy court explicitly retained jurisdiction 'over any matters related to or arising from the implementation of' the order approving the compensation provisions of the Letter of Intent." *Id.* at 54. The Court concluded, "Accordingly, the parties should proceed to a final determination by the bankruptcy court as to the breakup fee due to Bankers Trust (if any) under the Letter of Intent." *Id.*

Similarly, in the present case, the Bankruptcy Court explicitly retained jurisdiction to "construe and enforce the terms of the Keilin Letter, . . . any Application made by Keilin, and this order." (R., Ex. 4, at 5) As with the break-up fee in *Integrated Resources,* whether the success fee will be paid depends on whether certain future events occur. In addition, in the present case, the amount of money authorized to be paid as a success fee will not be determined until the Bankruptcy Court reviews Keilin's fee application under the criteria set forth in § 330. Thus, as in *Integrated Resources,* the amount of money owed, if any, is far from settled. As the Order does not permit the payment of the success fee until there are further proceedings in the Bankruptcy Court, it is not final.[7]

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[7] In *In re AroChem Corp.,* 176 F.3d 610 (2d Cir. 1999), the Second Circuit held that the Bankruptcy Court's denial of a motion to disqualify a Chapter 7 trustee's counsel was a final order for purposes of the appeal. The Second Circuit relied on its opinion in *In re Palm Coast, Matanza Shores Ltd. P'ship,* 101 F.3d 253, 256 (2d Cir. 1996), which had held that the Bankruptcy Court's order authorizing a trustee to retain a firm was final. The *AroChem* Court noted:

> We are aware that *Palm Coast* may cut against the grain of prior Circuit precedent. *See,* e.g., *Dicola v. Am. S.S. Owners Mut. Protection & Indem. Ass'n* (*In re Prudential Lines*), 59 F.3d 327, 331 (2nd Cir. 1995) (restricting notion of "discrete dispute" to something more than "mere [] competing contentions with respect to separable issues") (citation and internal quotation marks omitted). . . . Nonetheless, once *Palm Coast* was decided it became binding precedent. . . .

AroChem, 176 F.3d at 620 n. 6. To the extent that *Palm Coast* and *AroChem* may show a more flexible approach to finality than *Integrated Resources* and other earlier Second Circuit cases, under the standards of the more recent cases, the portion of the Order dealing with the success fee still is not final. A key factor determining whether the bankruptcy court's decision was final in *AroChem* and *Palm Coast* was

(Continued on following page)

Under 28 U.S.C. § 158(a)(3), a district court can consider an interlocutory bankruptcy court order with "leave of the court." In construing this section, courts have adopted the standard set forth in 28 U.S.C. § 1292(b), which ordinarily governs appeals from interlocutory district court orders to the courts of appeals. *See,* e.g., *In re Worldcom, Inc.,* 2003 U.S. Dist. LEXIS 11160, No. M-47, 2003 WL 21498904, at *9 (S.D.N.Y. Jun. 30, 2003); *In re Masterwear Corp.,* 1998 U.S. Dist. LEXIS 19563, No. 98 Civ. 0688, 1998 WL 879694, at *3 (S.D.N.Y. Dec. 16, 1998). Under § 1292(b), leave to appeal an interlocutory order may be granted when the order (1) "involves a controlling question of law," (2) as to "which there is substantial ground for difference of opinion," and (3) "an immediate appeal from the order may materially advance the ultimate termination of the litigation." 28 U.S.C. § 1292(b). Section 1292(b) is meant to be applied rarely: "Only 'exceptional circumstances [will] justify a departure from the basic policy of postponing appellate review until after the entry of a final judgment.'" *Klinghoffer v. S.N.C. Achille Lauro,* 921 F.2d 21, 25 (2d Cir. 1990) (quoting *Coopers & Lybrand v. Livesay,* 437 U.S. 463, 475, 57 L. Ed. 2d 351, 98 S. Ct. 2454 (1978)). In the case at hand, assuming the U.S. Trustee is appealing the portion of the Order dealing with Keilin's success fee, she cannot meet all three requirements of § 1292(b). Resolving this issue now will not "materially advance the ultimate termination of the litigation." The Order stated that the success fee

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that the court did not suggest that its order would be reconsidered. However, in the present case, the Order specifically provides that there will be further review of the success fee before it can be paid.

would be authorized only in certain circumstances, which may or may not occur. Deciding an issue now, which may never need to be decided, does not help to advance the litigation. Furthermore, I see no "exceptional circumstances" that would justify immediate review.

In addition, the doctrine enunciated in *Cohen v. Beneficial Industries Loan Corp.*, 337 U.S. 541, 93 L. Ed. 1528, 69 S. Ct. 1221 (1949), allows appeal from certain interlocutory bankruptcy court orders if they "[1] conclusively determine the disputed question, [2] resolve an important issue completely separate from the merits of the action, and [3 are] effectively unreviewable on appeal from a final judgment." *AroChem,* 176 F.3d at 618 (quoting *Firestone Tire & Rubber Co. v. Risjord,* 449 U.S. 368, 375, 66 L. Ed. 2d 571, 101 S. Ct. 669 (1981)) (internal quotation marks omitted). At the very least, this appeal does not meet the third requirement.

However, the portion of the Order authorizing the payment of $1.4 million is final and must be reviewed here. The USWA Letter stated that the reimbursement of fees and expenses would be "subject to an overall cap of $1.5 million for the period commencing October 15, 2001, and ending April 15, 2002, or upon payment of $1.5 million, whichever occurs later." (R., Ex. 1, USWA Letter at 1) The Order changed this amount to $1.4 million (R., Ex. 5, at 3), and gave no indication that this amount would be adjusted or reconsidered at some future date.

The USWA Letter, which was adopted by the Order, does provide that Bethlehem will not reimburse the USWA until certain statements are filed by the professionals. (R., Ex. 1, USWA Letter at 1) If any party objects to an item and the parties cannot resolve the dispute, the dispute will

be resolved by the Bankruptcy Court. (*Id.*) Under the terms of the USWA Letter, Bethlehem will not make the payment until the dispute is resolved. (*Id.*) These provisions weigh against finding that this portion of the Order is final, because they show that further proceedings in the Bankruptcy Court regarding the reimbursements are at least possible.

However, I do not read the Order as contemplating that the U.S. Trustee can object again to the legality of authorizing fee reimbursements under § 363(b), as this issue was already debated by the parties and conclusively resolved by the Bankruptcy Court in the January 7, 2002 Order. That Order was the final word by the Bankruptcy Court on the legality of the reimbursements.

Furthermore, the January 7, 2002 Order does not condition authorization for reimbursement of the professionals on further proceedings in the Bankruptcy Court. As in *Palm Coast,* where the Second Circuit found that an order was final, "nothing in the order of the bankruptcy court . . . indicates any anticipation that the decision will be reconsidered." *Palm Coast,* 101 F.3d at 256; *see* also *AroChem Corp.,* 176 F.3d at 620 ("Neither the bankruptcy court nor the district court suggested that its order would be reconsidered."). A finding that the Order was not final with respect to the reimbursement agreement would mean that the U.S. Trustee could not appeal until after reimbursement was actually made. At that point there might not be a new order from which to appeal – if the parties did not bring a dispute to the Bankruptcy Court for resolution. As the Order allows reimbursement without further order by the Bankruptcy Court, it is final for purposes of this appeal, and must be reviewed by this court under 28 U.S.C. § 158(a)(1).

III.

A district court reviews the bankruptcy court's findings of fact for clear error, and reviews conclusions of law de novo. *See AroChem,* 176 F.3d at 620. The U.S. Trustee's appeal raises a purely legal question – whether subsections 503(b)(3)(D) and (b)(4) preclude a bankruptcy court from authorizing reimbursement by the debtor under § 363(b) of a creditor's professional fees. This court reviews that question de novo. *See In re Air Crash Off Long Island, New York, on July 17, 1996,* 209 F.3d 200, 202 (2d Cir. 2000) (questions of statutory construction are reviewed de novo).

The Bankruptcy Court authorized the reimbursement pursuant to § 363(b) of the Bankruptcy Code, which provides that a bankruptcy court may authorize a debtor to "use, sell, or lease, other than in the ordinary course of business, property of the estate," 11 U.S.C. § 363(b)(1), and under § 105(a), which gives the court authority to issue "any order, process, or judgment that is necessary and appropriate to carry out the provisions of this title," 11 U.S.C. § 105(a).

The U.S. Trustee argues that subsections 503(b)(3)(D) and (b)(4) of the Bankruptcy Code provide specifically for reimbursement of creditors' professional fees by the estate. These subsections allow such fees to be classified as administrative expenses, and paid by the estate, but only if the expenses were incurred in making a "substantial

contribution to the case."[8] Courts have defined a "substantial contribution" as one that substantially and directly benefits the estate. *See,* e.g., *In re Hooker Invs., Inc.,* 188 B.R. 117, 120-21 (S.D.N.Y. 1995) (relevant factors in determining whether an applicant has made a substantial contribution are "whether the services in question were provided to benefit all parties in the case; whether the services conferred a direct, significant and demonstrably positive benefit upon the estate; and whether the services were duplicative of services performed by others"); *In re*

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[8] Section 503 provides:

> (b) After notice and a hearing, there shall be allowed administrative expenses . . . , including –
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> . . . (3) the actual, necessary expenses other than compensation and reimbursement specified in paragraph (4) of this subsection, incurred by –
>
> . . . (D) a creditor, an indenture trustee, an equity security holder, or committee representing creditors or equity security holders other than a committee appointed under 1102 of this title, in making a substantial contribution in a case under chapter 9 or 11 of this title;
>
> . . . (4) reasonable compensation for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under paragraph (3) of this subsection, based on the time, the nature, the extent, and the value of such services, and the cost of comparable services other than in a case under this title, and reimbursement for actual, necessary expenses incurred by such attorney or accountant;
>
> . . . .

11 U.S.C. § 503. Administrative expense claims allowed pursuant to Section 503 are accorded first priority status in a bankruptcy case and are paid directly from the bankruptcy estate before other claims, including claims of unsecured creditors. 11 U.S.C. § 507(a)(1). The reorganization plan must provide for the full payment of administrative expenses. 11 U.S.C. § 1322(a)(2).

Alert Holdings Inc., 157 B.R. 753, 757 (Bankr. S.D.N.Y. 1993) ("Efforts undertaken by creditors solely to further their own self-interest are not compensable under section 503(b). The integrity of § 503(b) can only be maintained by strictly limiting compensation to extraordinary creditor actions which lead directly to tangible benefits to the creditors, debtor or estate.") (citations omitted). The U.S. Trustee argues that "in essence, the Debtors' Motion contends that the USWA will have to retain professionals to advise it in its negotiations with the Debtors" but "it is well established that the costs and expenses incurred by a creditor in representing itself are not legitimate administrative expenses." (U.S. Trustee's Br. at 10).

According to the U.S. Trustee, the "sole statutory avenue for an individual creditor to have its professional fees reimbursed is as an administrative expense." (U.S. Trustee's Br. at 6) The U.S. Trustee argues that authorizing reimbursement of the professional fees and expenses at the beginning of the case allows the USWA to avoid the substantial contribution requirement of subsections 503(b)(3)(D) and (b)(4). With this arrangement, the USWA guarantees that its expenses will be paid regardless of whether it contributes to a successful reorganization. (U.S. Trustee's Reply Br. at 6) The U.S. Trustee argues that by relying on the general provisions of § 105(a) and § 363(b), the Order "threatens to create an exception that will swallow the Bankruptcy Code's detailed language limiting administrative expenses and professional fees." (U.S. Trustee's Br. at 5)

The U.S. Trustee points out that there are specific sections of the Bankruptcy Code that deal with the payment of professional fees. The debtor in possession can retain professionals under § 327, and official committees of

creditors and equity security holders can employ professionals under § 1103. These professionals can be paid "reasonable compensation" from the estate upon approval by the bankruptcy court according to specific criteria set forth in § 330. Thus, according to the U.S. Trustee, there are specific procedures and standards in the Bankruptcy Code for payment of professional fees, and these procedures and standards cannot be avoided by authorizing fees under the broad language of § 363(b) and § 105(a).

Bethlehem and the USWA (the "appellees") respond that the Bankruptcy Court acted within its discretion to approve the arrangement under § 105(a) and § 363(b), and that subsections 503(b)(3)(D) and (b)(4) do not bar such an arrangement. The appellees argue that a request to use the debtor's funds under § 363(b) is allowed if the debtor shows a good business reason for the transaction. The appellees argue that payment of these fees was necessary for the USWA to participate fully in negotiations to modify the collective bargaining agreements, and these modifications were vital to a successful reorganization.

Bethlehem points out that the Committee supported the reimbursement arrangement (Bethlehem's Br. at 2) and asserts that the "economic stakeholders and the Bankruptcy Court determined that the relief granted by the Order would enhance, benefit, and serve the interests of all parties" (*id.* at 15). Bethlehem argues that its "ability to reorganize should not be shackled by an inflexible, literalist statutory interpretation that is constructed by an entity that does not hold an economic interest in the reorganization of the Debtors." (*Id.* at 17)

The USWA argues that subsections 503(b)(3)(D) and (b)(4) were "inappropriate to the relief sought in the

Motion" because Bethlehem sought "authority to make the fee payments now, and not at the end of the case." (USWA's Br. at 11) The USWA argues also that this is not a case where a creditor seeks to recover costs and fees incurred by "representing itself" as a creditor collecting on its claims in a bankruptcy case. Rather, the USWA argues that it is engaged in an effort to restructure its labor agreements with Bethlehem "going forward." (*Id.* at 12) According to the USWA, the "focus of the parties' efforts is prospective" and is "not simply an effort to recover on pre-petition claims." (*Id.*)

The appellees emphasize that the USWA is not just any creditor, but rather the entity representing the largest constituency of unsecured creditors and the union representing most of Bethlehem's workers. (Bethlehem's Br. at 18) The appellees point to "similar orders entered in other chapter 11 cases of steel industry companies that involve the USWA." (*Id.* at 16 (citing *In re Republic Techs. Int'l, LLC,* Ch. 11 Case No. 01-51117 (Bankr. N.D. Ohio Dec. 4, 2001); *In re LTV Steel Co., Inc.,* 2001 Bankr. LEXIS 635, Ch. 11 Case No. 00-43866 (Bankr. N.D. Ohio Mar. 21, 2001)).[9]

Bethlehem compares the present arrangement to the authorization of break-up fee[10] agreements under § 363(b)

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[9] The Order in *Republic Technologies* is attached to USWA's brief. (USWA's Br., Ex. 1) The Order in *LTV Steel* is attached to Bethlehem's motion filed with the Bankruptcy Court. (R., Ex. 1) It does not appear that either of these orders was reviewed by a district court.

[10] "A break-up fee, or more appropriately a termination fee, is an incentive payment to a prospective purchaser with which a company fails to consummate a transaction." *In re Integrated Resources, Inc.,* 147 B.R. 650, 652 (S.D.N.Y. 1992).

and cites this court's opinion in *In re Integrated Resources, Inc.*, 147 B.R. 650 (S.D.N.Y. 1992). (Bethlehem's Br. at 11) Bethlehem also compares the present case to cases involving reimbursement requests for due diligence costs incurred by prospective purchasers of debtors' assets. Bethlehem says, "Interestingly, the U.S. Trustee rarely objects to the concept of presale reimbursement agreements" and cites several cases including *Integrated Resources*. (Bethlehem's Br. at 14)

In *Integrated Resources,* the debtor in possession, Integrated, sought authorization from the Bankruptcy Court to enter into a break-up fee and expense reimbursement agreement with Bankers Trust, a potential funder of a reorganization plan. The Bankruptcy Court approved the agreement, apparently pursuant to § 363(b). *See In re Integrated Resources, Inc.*, 135 B.R. 746, 750 (Bankr. S.D.N.Y. 1992).[11] This court affirmed the Bankruptcy Court's order, without specific reference to § 363(b). *In re Integrated Resources, Inc.*, 147 B.R. 650 (S.D.N.Y. 1992).

In her reply brief, the U.S. Trustee acknowledges that one element of the compensation arrangement in

[11] The Bankruptcy Court did not discuss § 363(b), except to say: "When a sale of the debtor's assets outside the ordinary course of business is proposed, Code § 363, bankruptcy courts will carefully scrutinize the use of break-up fees." *Integrated Resources,* 135 B.R. at 750. The Second Circuit's opinion in the case said that "Integrated filed a motion seeking the bankruptcy court's approval of the compensation provisions of the Letter of Intent pursuant to 11 U.S.C. §§ 105 and 363(b)." *In re Integrated Resources,* 3 F.3d 49, 51 (2d Cir. 1993). The Second Circuit dismissed the appeal in that case for lack of jurisdiction. *Id.* at 51.

Integrated Resources was the reimbursement of Bankers Trust's professional fees incurred in connection with conducting its due diligence. However, the U.S. Trustee says, "Although the professional fees were not analyzed separately under section 503, the substantial contribution standard was effectively applied." (U.S. Trustee's Reply Br. at 5)

That argument stretches *Integrated Resources* beyond recognition. The Bankruptcy Court and this court in *Integrated Resources* did not mention subsections 503(b)(3)(D) or (b)(4), the "substantial contribution" standard, or administrative expenses. The debtor in possession, Integrated, brought the motion under § 363(b) for authorization to enter into the fee agreement with Bankers Trust. Bankers Trust did not seek the fees directly by means of an application under subsections 503(b)(3)(D) and (b)(4). Indeed, it appears that Bankers Trust was not a creditor,[12] and thus could not have applied for reimbursement under those provisions.

"It has become increasingly common in section 363 sales of significant portions of an estate's assets for the prospective buyer to demand a breakup fee or other protection in the event that the sale is not consummated." 3 Collier on Bankruptcy § 363.03[7] (15th ed. 2002).[13]

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[12] The Bankruptcy Court refers to Bankers Trust as a "third party plan funder." *Integrated Resources*, 135 B.R. at 748.

[13] This treatise argues:

> In negotiated section 363(b) sales, as with nonbankruptcy sales of assets, it may sometimes be necessary to offer incentives to bidders in order to maximize the price obtained. In general, the trustee or debtor in possession, who has a

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Several bankruptcy courts have refused to approve break-up fee and expense reimbursement agreements between debtors in possession and potential buyers. However, these courts have not held that they lack statutory authority under the Bankruptcy Code to permit such payments; rather, they have withheld approval because the agreements were found not in the best interests of various parties. *See,* e.g., *In re APP Plus, Inc.,* 223 B.R. 870 (Bankr. E.D.N.Y. 1998) (Chapter 11 trustee moved for order authorizing sale of substantially all of debtor's assets and authorization of break-up fee and topping fee arrangement; Bankruptcy Court approved break-up fee arrangement but refused to approve topping fee agreement); *Matter of Tiara Motorcoach Corp.,* 212 B.R. 133 (Bankr. N.D. Ind. 1997) (debtor moved under § 363 for authorization of the sale of certain assets and approval agreement to pay a break-up fee; Bankruptcy Court refused to approve the break-up fee agreement, finding that it was not in the best interests of the estate, creditors and equity holders); *In re Am. W. Airlines,* 166 B.R. 908, 913 (Bankr. D. Ariz. 1994) (applying § 363(b) and holding that "payment of the contemplated break-up fee, in any amount, is not in the best interest of the estate, the creditors or the equity holders" but expense reimbursement

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fiduciary duty to represent the estate's interests, should be able to exercise judgment with respect to bidding incentives. Consequently, although a court should certainly review the trustee's or debtor in possession's agreement to provide bidding incentives, the court should approve such agreements unless they are unreasonable or appear more likely to chill the bidding process than to enhance it.

3 Collier on Bankruptcy § 363.03[7] (15th ed. 2002) (footnotes omitted).

provisions "are in the best interests of the estate" and would be approved).

The Third Circuit, in *Calpine Corp. v. O'Brien Envtl. Energy, Inc. In re O'Brien Environmental Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999), refused to approve payment of a break-up fee. Initially, the Bankruptcy Court refused to approve a break-up fee and expense agreement between a potential buyer (Calpine) and the debtor in possession, O'Brien. However, the Court said that it might be willing to permit Calpine to seek the fees at the end of the process. After Calpine lost the auction for the debtor's assets, Calpine filed an application for payment of a break-up fee and expenses. The Bankruptcy Court denied that application. Calpine appealed both orders. The appellees asserted that Calpine lacked standing to challenge the earlier order because only O'Brien had statutory authority to move for approval of the compensation provisions at the earlier hearing, and thus only O'Brien could appeal the denial of the approval. *Id.* at 530. The Third Circuit agreed that Calpine lacked standing to challenge this order. *Id.* at 531.

However, the Third Circuit did consider Calpine's challenge to the later order. The Court began its discussion by stating that there was "some confusion concerning the legal basis on which Calpine made and is prosecuting" its motion. *Id.* at 531-32. The Court said, "Neither Calpine nor the Bankruptcy Court have cited any support for the proposition that courts may create a right to recover from the bankruptcy estate where no such right exists under the Bankruptcy Code." *Id.* at 532. The Third Circuit said: "We decline the invitation to develop a general common law of break-up fees. We instead consider whether any provision of the Bankruptcy Code, as it is currently written, authorizes the award of break-up fees and expenses to

an unsuccessful bidder at the plan-based sale of a debtor's assets." *Id.* at 532. The Court found that the "most likely source of authority for Calpine's motion appears to be 11 U.S.C. § 503," and it decided to "treat Calpine's arguments as addressing whether it is entitled to receive break-up fees and expenses under that provision." *Id.* at 532. According to the Court, section 503(b)(1)(A) applied, which allows "the actual, necessary costs and expenses of preserving the estate" to be treated as administrative expenses. Applying this section, the Third Circuit concluded that "awarding break-up fees and expenses to Calpine was not actually necessary to preserve the value of O'Brien's estate" and affirmed the Bankruptcy Court's decision to deny approval of the arrangement.

O'Brien deals with the case of an unsuccessful bidder seeking payment of a fee from the estate after the bidding has concluded. *O'Brien* did not address whether, under § 363(b), a bankruptcy court can authorize a debtor in possession to enter into a reimbursement agreement with a potential buyer. However, the opinion can be read as holding that § 503(b) is the only source for approval of the payment of these fees. To the extent that *O'Brien* does so hold, the case is helpful to the U.S. Trustee – although she does not cite it.

O'Brien may be correct that the only way an unsuccessful bidder can itself seek payment of a break-up fee and expenses from the estate is under 503(b). However, I think the better view is that pursuant to § 363(b), a bankruptcy court may authorize a debtor in possession to enter into a reimbursement agreement with a potential buyer. *See* 3 Collier on Bankruptcy § 363.03[7] (arguing that bankruptcy courts should approve these agreements

unless they are unreasonable or appear more likely to chill the bidding process than to enhance it).

The break-up fee cases are examples of courts allowing (or refusing to allow) the debtor in possession to reimburse the expenses of potential buyers in connection with a sale of the estate's assets under § 363(b). The cases are relevant by way of analogy, but do not address the precise question at issue here – whether reimbursement of a creditor's professional fees can be allowed under § 363(b). Neither party cites, and I have not found, any district or circuit court case addressing this question. For the reasons described below, I conclude that subsections 503(b)(3)(D) and (b)(4) do not preclude reliance on § 363(b) to authorize a debtor in possession to reimburse a creditor's professional fees.

Section 363(b) and subsections 503(b)(3)(D) and (b)(4) serve different purposes in bankruptcy proceedings. Section 503 allows entities that incurred certain expenses to request payment from the estate. *See* 11 U.S.C. § 503(a) ("An entity may timely file a request for payment of an administrative expense. . . ."). Under subsections 503(b)(3)(D) and (b)(4), a creditor can file an application with the bankruptcy court for payment of already-incurred professional fees. After notice and a hearing, if the bankruptcy court determines that the creditor incurred expenses "in making a substantial contribution in a case," then the court will allow the creditor's reasonable professional fees to be treated as administrative expenses. *See* 11 U.S.C. § 503(b)(3)(D) & (b)(4).

Section 363, on the other hand, governs the use of funds by the debtor in possession while it operates its business after the bankruptcy petition is filed. Under

§ 363(c), a debtor in possession "may use property of the estate in the ordinary course of business without notice or a hearing." 11 U.S.C. § 363(c). Under § 363(b), a debtor in possession "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b). Thus, under § 363(b), if the debtor in possession wants to use funds from the estate for a transaction outside the ordinary course of business, the debtor must obtain advance approval from the bankruptcy court.

Section 363(b) does not permit the debtor in possession to use funds solely to benefit a creditor. If the payment of a creditor's fees were simply aimed at helping the creditor promote its own self-interest, the payment would not be permitted under § 363(b). The bankruptcy court may not authorize the use of funds under § 363(b) unless it finds "a good business reason" for the expenditure. *See In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983) ("The rule we adopt requires that a judge determining a § 363(b) application expressly find from the evidence presented before him at the hearing a good business reason to grant such an application."). In *Lionel,* the Second Circuit said that the "the history surrounding the enactment in 1978 of current Chapter 11 and the logic underlying it buttress our conclusion that there must be some articulated business justification, other than appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business before the bankruptcy judge may order such disposition under section 363(b)." *Id.* at 1070.

In *Lionel,* "the only reason advanced for granting the request to sell Lionel's 82 percent stock interest in Dale was the Creditors' Committee's insistence on it," *id.* at

1071, and the Court found this reason "insufficient as a matter of fact because it is not a sound business reason and insufficient as a matter of law because it ignores the equity interests required to be weighed and considered under Chapter 11," *id.* The Court added that "in fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike." *Id.*

The case at hand does not present a situation where a creditor incurs expenses in attempting to collect on pre-petition claims and then seeks reimbursement from the estate. That situation is covered by § 503, and expenses will be paid only if the creditor's actions were helpful to the estate.

By contrast, in the present case, Bethlehem determined that paying the USWA's expenses was a good business decision and would help develop a reorganization plan. The Committee agreed that it was "necessary and appropriate for the USWA to receive competent and comprehensive advice and counsel" and that it was "appropriate for the Debtors to reimburse the USWA for the reasonable cost of such advice and counsel." (R., Ex. 3, at 3) The pre-petition lenders group agreed. (R., Ex. 5, at 47) Finally, the Bankruptcy Court determined that the reimbursement arrangement was "in the best interests of the Debtors and all parties in interest." (R., Ex. 4, at 2)

The authorization of certain types of payments under § 363(b) is not prohibited simply because there is another section of the Bankruptcy Code related to the same type of

payment. The U.S. Trustee objects that relying on § 363(b) to authorize the reimbursements "threatens to create an exception that will swallow the Bankruptcy Code's detailed language limiting administrative expenses and professional fees." (U.S. Trustee's Br. at 5) However, subsections 503(b)(3)(D) and (b)(4) are not rendered meaningless simply because in certain unique circumstances a bankruptcy court approves a debtor's motion to enter into an agreement to reimburse a creditor for professional fees. In most cases, a debtor will make no such motion, as it will not be in its business interest to do so – or the court will refuse approval under § 363(b). Thus, in most cases, if a creditor wants to be reimbursed, it must file an application under subsections 503(b)(3)(D) and (b)(4). Those provisions continue to serve a purpose.

In sum, subsections 503(b)(3)(D) and (b)(4) do not bar a bankruptcy court from allowing a debtor in possession to reimburse a creditor for professional fees – provided, of course, that the standard for allowing transactions under § 363(b) has been met.

In addition, under the circumstances present here, the Bankruptcy Court did not err in its application of § 363(b).[14] To approve a transaction under § 363(b), the

[14] Bankruptcy court orders approving transactions under § 363(b) – assuming that the transaction is of a type that as a matter of law can be approved under this section – are reviewed by examining whether there is clear error in the bankruptcy court's finding that there was a good business reason to allow the transaction. If the decision is supported by the record, the appellate court will find that the order was not an abuse of discretion. *See In re Chateaugay Corp.*, 973 F.2d 141, 145 (2d Cir. 1992) ("The bankruptcy court was within its discretion, based on its consideration of all the factors . . . to determine that a good

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bankruptcy court must find that there is a good business reason to allow the transaction. In this case, the Bankruptcy Court found that the reimbursement arrangement was "in the best interests of the Debtors and all parties in interest." (R., Ex. 4 at 2)

The U.S. Trustee does not explicitly challenge that finding. The U.S. Trustee's papers argue only that subsections 503(b)(3)(D) and (b)(4) preclude the use of § 363(b), under any circumstances, to authorize a professional fee reimbursement arrangement between a creditor and debtor. Indeed, in her Statement of the Issue and Standard of Appellate Review, at the beginning of her brief, the U.S. Trustee forswears any fact-based argument, as follows:

> This issue on appeal is statutory construction, i.e., whether very specific requirements for compensation of a creditor in the case pursuant to section 503(b)(3)(D) and 503(b)(4) can be ignored in favor of sections 363(b) and 105(a) of the Bankruptcy Code. In appeals that principally

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business reason existed to proceed with the sale now even if the preferred stock amount does not ultimately benefit creditors. The finding that delay may so diminish the value of Aerospace's assets that creditors will lose more than the value of the preferred stock is supported by the record and justifies the bankruptcy court's decision."); *Lionel,* 722 F.2d at 1071 ("Thus, the approval of the sale of Lionel's 82 percent interest in Dale was an abuse of the trial court's discretion."); *see* also *Stephens Indus. v. McClung,* 789 F.2d 386, 388-89 (6th Cir. 1986) ("Accordingly, we review the Bankruptcy Court's order authorizing the sale of the assets [pursuant to § 363(b)] under an abuse of discretion standard. . . . In determining whether the Bankruptcy Court abused its discretion, this Court reviews the Bankruptcy Court's findings of fact under the 'clearly erroneous' standard. We review the Bankruptcy Court's conclusions of law, however, de novo." (citations omitted)).

> involve statutory construction, the standard of review is de novo.

(U.S. Trustee's Br. at 2) (citation omitted)

To be sure, the U.S. Trustee does state: "The Debtor's reliance on Section 363(b) presents the dangers addressed in *Lionel*. The Debtors agreed to USWA's demand for reimbursement of professional fees. Although no reasons are offered other than USWA's request, it is reasonable to assume that the Debtors hoped to pacify an important creditor." (U.S. Trustee's Br. at 14) However, the U.S. Trustee does not assert that the Bankruptcy Court's holding that the arrangement was "in the best interests of the Debtors and all parties in interest" (R., Ex. 4 at 2) was clearly erroneous or unsupported by the record. Moreover, the U.S. Trustee's airy claim that "no reasons are offered [for the fee reimbursements] other than USWA's request" is simply wrong. The USWA argued in its letter why it needed the money to help evaluate and negotiate the terms of a plan, and Bethlehem and the Committee and the pre-petition lenders agreed that the USWA's reasoned request was sound. In addition, in the proceedings before the Bankruptcy Court, the U.S. Trustee argued that § 363(b) did not provide a statutory basis for authorizing the reimbursement arrangement, and it does not appear from the record that she argued in the alternative that Bethlehem lacked a good business reason for entering into the agreement with the USWA. (*See* R., Ex. 2 & Ex. 5, at 39-44) Neither below nor here has the U.S. Trustee suggested that the Bankruptcy Court proceedings offended *Lionel*'s requirement that the finding of a "good business reason" be based on "evidence presented before . . . [the court] at the hearing." *Lionel*, 722 F.2d at 1071. There was no dispute about underlying facts; it was the legal conclusions flowing from those facts that were disputed. In any event, in this

case, Bethlehem determined for reasons summarized in the USWA Letter referred to on page 2, *supra,* that making the payments was in its business interest and the Committee and the pre-petition lenders agreed. The Bankruptcy Court's finding that the transaction was in the best interests of Bethlehem and all parties in interest was not clearly erroneous, and the decision to authorize the payments was not an abuse of discretion.

Finally, the U.S. Trustee argues that the Bankruptcy Court's reliance on § 105 was an abuse of discretion because "section 105 cannot be used to escape the limitations on administrative expenses imposed by section 503." (U.S. Trustee's Br. at 15) I agree that § 105 must be used in a manner that is consistent with the Bankruptcy Code. *See* 2 Collier on Bankruptcy § 105.01[2] (15th ed. 2002) ("Section 105 does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code. . . . " (citing *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197, 206, 99 L. Ed. 2d 169, 108 S. Ct. 963 (1988))). However, because § 363(b) provides a basis for allowing the reimbursement agreement, the use of § 105 in connection with § 363(b) to issue the Order was not an abuse of discretion.

For the reasons stated above, the Order of the Bankruptcy Court, to the extent that it allows reimbursement of up to $1.4 million in fees and expenses, is affirmed.

SO ORDERED:

Dated: July 23, 2003

Michael B. Mukasey,

U.S. District Judge